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## International Tax Planning as a Business Driver

Robert A. Agresta

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# **Penn State Journal of Law & International Affairs**

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## **INTERNATIONAL TAX PLANNING AS A BUSINESS DRIVER**

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## I. INTRODUCTION

Taxation is unique as the single most consistent function of government. For as long as the world has needed governments, governments have needed taxes. There have been few options available for governments to raise money that have been as successful and as simple. The word ‘tax’ itself first appeared in English in the 14<sup>th</sup> century. The Latin word *Taxare* means “to assess.” In England, the related words ‘tax’ and ‘task’ were commonly used referring to labour and money as a ‘duty’ respectively.<sup>1</sup> Because of their compulsory nature – as long as there have been taxes – there have also been strategies to avoid them. The imposition of duties has driven mass migrations, transitions in governments, riots and even wars.

Under the Egyptian Pharaohs ‘scribes’ raised funds however possible, including a tax on cooking oil. To ensure that the citizenry was using the taxed cooking oil and not a substitute, these early scribes conducted regular ‘audits’ of the citizens’ homes.<sup>2</sup> Governments have also emphasized one type of tax over another, relying on the value system of their citizenry, or even political goals in funding government operations. For example, some jurisdictions like the member states of the European Union rely more heavily on a consumption tax (or “Value Added Tax”). A consumption tax has the advantage of being easier to levy than an income tax or estate tax, because a consumption tax is collected automatically by a merchant whereas an income or estate tax requires a semi-voluntary declaration to be issued by the party being taxed.

In the world of tax, not only the rules, but also the enforcement mechanisms are varied based upon the values of the people. As people have run from taxes, governments have run after people. Governments around the world have taken different positions on which avoidance strategies are legal and which are forbidden. As an example of enforcement leniency, the Swiss authorities have implemented a system that is quite different than

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<sup>1</sup> *A Short History of Taxation*, NEW INTERNATIONALIST MAGAZINE (2008), <https://newint.org/features/2008/10/01/tax-history/> (last visited May 1, 2015).

<sup>2</sup> *Id.*

what is applied in much of the rest of the world. In Switzerland, failure to disclose a taxable event is an infringement that is among the lowest categories of criminal offenses and only subject to a fine.<sup>3</sup> In the United States, the use of tax enforcement is at the extreme opposite, drawing criticism over its alleged use as a political tool. Across the Atlantic, former tennis star, Boris Becker was accused of living in Germany while claiming tax residency in Monaco whereby he avoided paying 1.7 million Euros in taxes to the German government from 1991 to 1993. After admitting to evasion and being sentenced to pay a \$500,000 fine and serve 2 years of probation in Germany, Becker moved to Switzerland.<sup>4</sup>

The stakes are of course much higher among Corporate Multinationals. Boards of Directors owe a fiduciary duty to their shareholders, and that duty embraces obligations to deliver bottom line performance and yield.<sup>5</sup> This is counterbalanced by external obligations to ensure that the company meets its tax and regulatory obligations. These obligations are inversely correlated. As the board errs on the side of safety in its tax strategy, it returns less to its shareholders. This also drives down stock price and makes the company less competitive in cash draining activities like Research and Development. Contrarily as companies take greater risks in their tax strategies, they better meet their obligations to effectively manage the individual company's capital, optimize its competitiveness, and of course – its returns. This is directly reflected on the financial statements of the largest publicly traded companies. In 2013, Apple, Inc. made headlines when the United States Senate reported that America's largest company had avoided paying tax on \$102 billion of profits anywhere in the world by exploiting rules that made income

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<sup>3</sup> Pietro Sansonetti, *Tax evasion: The evolution of the Swiss Criminal Tax Law* *Tax evasion: The evolution of the Swiss Criminal Tax Law*, INT'L TAX REV. (Mar. 12, 2013), <http://www.internationaltaxreview.com/Article/3167155/Tax-evasion-The-evolution-of-the-Swiss-Criminal-Tax-Law.html> (last visited Apr 1, 2015).

<sup>4</sup> *Ex-Tennis Star Given 2 Years' Probation*, N.Y. TIMES (2002), <http://www.nytimes.com/2002/10/25/world/ex-tennis-star-given-2-years-probation.html> (last visited Mar 15, 2015).

<sup>5</sup> William M. Lafferty, Lisa A. Schmidt & Donald J. Wolfe, *A Brief Introduction to the Fiduciary Duties of Directors Under Delaware Law*, 116 PENN ST. L. REV. 837, (2012), <http://www.pennstatelawreview.org/116/3/116%20Penn%20St.%20L.%20Rev.%20837.pdf>.

from its European operations “sourceless,” and thus, not subject to tax anywhere.<sup>6</sup>

The realities of the varied sovereign tax opportunities are no surprise to authorities around the world. Tax systems have grown up organically and selfishly. In order to accommodate business in a rapidly globalizing world, governments have needed to make agreements with one another to preserve fairness in the way their tax systems interact; namely to avoid or limit double-taxation and to preserve equity by taxing all income as equally and fairly as possible. In January 2003, the Organization for Economic Co-operation and Development (“OECD”) introduced the Model Tax Convention, which was designed to provide a framework by which countries were to mitigate the effects of double taxation.<sup>7</sup> Apple was nonetheless ultimately able to accomplish its tax plan by manipulating tax treaties, residency rules and the specific treatment of certain types of income in different jurisdictions.<sup>8</sup>

Governments are held politically accountable through the ballot box and their leaders want to earn votes and political capital by attracting large corporations to their geographic and economic bases. In response to these pressures, leaders of high-tax countries like the United States, Germany and the United Kingdom in particular, have called for a treaty system to limit tax jurisdiction competition of this nature.<sup>9</sup> This war cry resulted in the creation of a project. Spearheaded by the OECD, this project is known as the Action Plan on Base Erosion and Profit Shifting (“BEPS”) and it was issued by the OECD on July 19, 2013 with the goal of reviewing the

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<sup>6</sup> Emily Cohn, *Apple Paid Little Or No Taxes To Any Government On Billions In Profits: Senate Report*, HUFFINGTON POST (May 20, 2013), [http://www.huffingtonpost.com/2013/05/20/apple-senate-report-offshore-tax-structure\\_n\\_3308741.html](http://www.huffingtonpost.com/2013/05/20/apple-senate-report-offshore-tax-structure_n_3308741.html) (last visited Mar 1, 2015).

<sup>7</sup> OECD, *Articles of the Model Convention With Respect to Taxes on Income and on Capital* (2003), <http://www.oecd.org/tax/treaties/1914467.pdf> (last visited Feb 12, 2015).

<sup>8</sup> *Supra* note 6.

<sup>9</sup> *Who are the BEPS supporters?*, TAX ADVISER MAGAZINE (2014), <http://www.taxadvisermagazine.com/article/who-are-beps-supporters> (last visited Feb. 10, 2015).

interaction of nations' tax systems and proposing changes in international taxation laws.<sup>10</sup> According to the OECD:

Base erosion and profit shifting (BEPS) is a global problem which requires global solutions. BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid. BEPS is of major significance for developing countries due to their heavy reliance on corporate income tax, particularly from multinational enterprises (MNEs).

In an increasingly interconnected world, national tax laws have not always kept pace with global corporations, fluid movement of capital, and the rise of the digital economy, leaving gaps that can be exploited to generate double non-taxation. This undermines the fairness and integrity of tax systems. Fifteen specific actions are being developed in the context of the OECD/G20 BEPS Project to equip governments with the domestic and international instruments needed to address this challenge. The first set of measures and reports were released in September 2014. Combined with the work to be completed in 2015, they will give countries the tools they need to ensure that profits are taxed where economic activities generating the profits are performed and where value is created, while at the same time give business greater certainty by reducing disputes over the application of international tax rules, and standardising [sic] requirements. For the

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<sup>10</sup> OECD BEPS Project - EY Canada, EY CANADA - EY - CANADA (2016), <http://www.ey.com/CA/en/Services/Tax/Tax-BEPS> (last visited Jun 20, 2017).

first time ever in tax matters, non-OECD/G20 countries are involved on an equal footing.<sup>11</sup>

As tax jurisdiction competition becomes limited, the central questions presented by our modern world is (i) can tax still drive business decisions for multinational corporations and (ii) to what extent does tax drive those decisions in today's globalized environment?

## II. TAX JURISDICTION COMPETITION AS A THEME

In tax planning it is easy to become myopic — only seeing tax as a reason to make a decision about where to locate a business component. However, a number of factors drive major business decisions and more often there is a balancing act between the interests and value proposition of each business driver especially in choosing a venue for a business headquarters, operation, subsidiary or branch. Consider the non-tax reasons driving these decisions. These include preserving logical group and legal structure that appeals to simplicity and predictability, which is something appealing prospective investors. They also include preserving the subsidiaries' balance sheets and thus their financing capabilities. Decision makers cannot ignore political and economic stability in the jurisdiction nor the regulatory requirements.

In 2009 McKinsey Consulting conducted a global study entitled *How companies make good decisions* in which 34% of executive respondents cited “expansion into new products, services or geographies” as the driving factor in decision making compared to 21% citing “organizational change for other reasons,” which based upon the alternatives would encompass tax and regulatory reasons. When asked about the “general goal of [any] given type of decision,” 78% cited revenue growth as the driving factor, while only 22% cited cost savings, which would likewise encompass tax planning.<sup>12</sup>

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<sup>11</sup> *About BEPS and the inclusive framework*, OECD <http://www.oecd.org/tax/beps-about.htm> (last visited Jun 20, 2017).

<sup>12</sup> Massimo Garbuio, Dan Lovalla & Patrick Viguerie, *How companies make good decisions*, McKinsey Global Survey Results, MCKINSEY & COMPANY (Jan. 2009),



The implications of these results show that in essence tax jurisdiction competition can have a marginal impact on business decisions, however the implications of even the most favorable structure is limited because of competing drivers influencing executive decision making. Based upon the McKinsey study and the OECD BEPS response to tax jurisdiction competition, we can draw the conclusion that if we assume for the sake of discussion that the risk factors among different tax strategies are the same, then the attractiveness of a tax regime will drive a business decision toward a tax strategy encompassing that regime:

- (1) to the extent it doesn't compete with other factors;
- (2) is relatively simple to implement; and
- (3) provides for a real and appreciable tax savings.

#### A. How Tax Jurisdiction Competition Works

There are several tax-oriented factors that can drive a tax strategy and the corresponding establishment of basic holding structures implicating low-tax and no-tax jurisdictions.

The first and most obvious goal is that companies seek to reduce withholding taxes, or the combined income taxes that the company must pay on its operations both locally in the investors' country and in the country which hosts the operations by using tax treaties. The second goal is to protect corporate profits from local capital gains tax by using tax treaties. These factors are what the OECD BEPS project has addressed in what is called BEPS Actions 2 (Hybrid mismatch arrangements) and 6 (Preventing Treaty Abuse).<sup>13</sup>

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[http://www.mckinsey.com/insights/strategy/how\\_companies\\_make\\_good\\_decisions\\_mckinsey\\_global\\_survey\\_results](http://www.mckinsey.com/insights/strategy/how_companies_make_good_decisions_mckinsey_global_survey_results) (last visited May 1, 2015).

<sup>13</sup> BEPS - Frequently Asked Questions, OECD, <http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm> (last visited Mar 1, 2015); BEPS Action 2 - Branch Mismatch Structures, OECD (2016), <http://www.oecd.org/tax/beps/Discussion-draft-Action-2-Branch-mismatch-structures.pdf> (last visited Mar. 15, 2017).

The third goal is to provide tax efficiency for the movement of cash, and the fourth is to implement tax-efficient financing structures. This fourth factor is addressed by the OECD BEPS project in BEPS Actions 8 (Transfer pricing of intangibles) and 13 (Transfer pricing documentation).<sup>14</sup>

1. *Tax Treaties and Source and Residency Rules*

People move around, but have the advantage for tax purposes of only being able to be in one place at a time. If a miner for gold in South Africa, most would agree that the source of that gold is South Africa. Let's assume that miner is paid for his work and work-product (the gold) in South Africa; he of course is subject to tax in South Africa. This is called his "Source Income" and is taxed at the source.<sup>15</sup> If however, it happens that this miner is a resident of neighboring Zimbabwe then he is also subject to tax on his income on the basis of his residency in Zimbabwe.<sup>16</sup> This is called "Residency Income." To go a step further, if it happens that this miner is a citizen of the United States as defined by the United States tax code, the United States tax code provides that his income wherever in the world it may be sourced will be taxed by the United States.<sup>17</sup> This is where the OECD model convention comes into play. Article 23 governs how to handle the above scenario. There are two basic options Article 23A, known as the "Exemption Method" and Article 23 B, known as the "Credit Method."<sup>18</sup> As the names indicate, the Exemption Method involves exempting income from taxation in one of the two contracting states from any tax whatsoever. The Credit Method involves crediting the tax paid in one state against the tax paid in the other contracting state. The model treaty distinguishes income derived from various types of activities and allocates the income to more closely align with the source country.

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<sup>14</sup> *Id.*

<sup>15</sup> BLACK'S LAW DICTIONARY (2d ed.).

<sup>16</sup> Clive Mphambela, *Residence-based tax system commendable*, THE ZIMBABWE INDEPENDENT (Mar. 1, 2013), <http://www.theindependent.co.zw/2013/03/01/residence-based-tax-system-commendable> (last visited Mar 12, 2015).

<sup>17</sup> INTERNAL REVENUE CODE, § 7701(b).

<sup>18</sup> *Supra* note 7.

Unfortunately for our miner, there is no double-taxation treaty between the United States and Zimbabwe. As a result the miner must pay tax on the income “in the same way and at the same rates shown in the instructions for the applicable U.S. tax return.”<sup>19</sup> In other words, our miner will be subject to taxation on the same income, both at the applicable rate in Zimbabwe and the United States.

If however, our miner moves across the border to South Africa, his income is taxed only once in South Africa and pursuant to Article 23 of the Tax Convention with South Africa, our Miner would be able to apply as a credit, the tax paid in South Africa against the tax due in the United States.<sup>20</sup>

Unlike a natural person, an entity such as a Corporation, Limited Liability Company or Trust is much more difficult to locate geographically for residency purposes when these entities operate on a global level. Consider that a Corporation might be formed in one jurisdiction, but have operations in many foreign jurisdictions and be managed in yet another jurisdiction. Out of 23 major economies surveyed by the accounting firm Deloitte, four placed their residence in the place of incorporation and sixteen placed it by using some form of a “place of effective management” standard.

<u>Incorporation</u>	<u>Place of effective management</u>	<u>Incorporation and place of effective management</u>	<u>Registration</u>
Estonia, Hong Kong, Russia, United States	Denmark	Austria, Canada, China, Cyprus, Czech Republic, Germany, Greece, Hungary, Ireland, Luxembourg, Malta, The Netherlands, Portugal, Romania, South Africa	Denmark, Sweden, Ukraine <sup>21</sup>

<sup>19</sup> *United States Income Tax Treaties - A to Z*, INTERNAL REVENUE SERVICE, <http://www.irs.gov/Businesses/International-Businesses/United-States-Income-Tax-Treaties---A-to-Z> (last visited July 2, 2015).

<sup>20</sup> *Tax Convention With South Africa*, INTERNAL REVENUE SERVICE (Jan. 1, 1998), <http://www.irs.gov/pub/irs-trty/safrica.pdf> (last visited July 2, 2015).

<sup>21</sup> *Survey into substance, place of residence and tax avoidance*, DELOITTE (Dec. 6, 2012), <http://www2.deloitte.com/content/dam/Deloitte/nl/Documents/tax/deloitte-nl-nederland-geen-belastingparadijs.pdf> (last visited June 10, 2015).

As discussed in the Deloitte survey:

When a company is subject to tax because the place of effective management is in the state concerned, most countries take into account facts and circumstances. This usually is an open standard, but several factors can be taken into account. In almost all cases it would be decisive where the central management is performed and the main business decisions are taken. This is not necessarily the place where the day-to-day management takes place. Other relevant factors that can be taken into account are the place where the directors reside or, more formally, the place of the registered office. Some countries apply only one of above criteria to determine the tax liability of a company, other countries apply both criteria besides each other.

\* \* \*

*In addition to this table, please note that most countries stated the place of effective management under bilateral tax treaties to be decisive for determining the place of residence in the event of dual resident companies.<sup>22</sup>*

It is the very nature of this difference in establishing tax residency that tax planners have traditionally sought to take advantage of in planning zero-tax strategies like those employed by Apple, Inc. identified and discussed generally above.

## 2. *Intra-Europe and International Tax Competition*

One of the broadest differences between the European Union and the United States is the federal/supranational competency to levy taxes. Although such a power is contemplated within the EEA treaty, it has never been exercised by European Authorities and has otherwise been left to the Member States.<sup>23</sup> The United States however, has exercised its direct authority to tax and levy pursuant to

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<sup>22</sup> *Id.*

<sup>23</sup> EEA Treaty art. 115, *opened for signature* May 2, 1992.

the United States Constitution, which has been powerfully implemented from the beginning.<sup>24</sup>

This distinction is significant because these factors give the European Union a powerful pro-jurisdictional competition slant. The United States on the other hand consolidates its power through its tax base and collects the lions share of corporate and personal income taxes paid by its subjects through its Internal Revenue Service (“IRS”), as opposed to the much smaller rates collected by the states.

Thus, while certain states are more attractive because they levy no corporate income tax, all U.S. Corporations are subject to tax at 35% for their 2014 taxable income at or above \$18,333,333, which covers every major U.S. Corporation.<sup>25</sup> In the United States, as in most parts of the world, a Corporation is taxed as an entity itself on its annualized taxable gross income. The income that it distributes to its shareholders is subsequently taxed a second time at the shareholder level as a dividend. The dividend tax is calculated on a bracket scale that corresponds to that person’s ordinary income tax bracket.<sup>26</sup> There are two scales divided into Ordinary Dividends and Qualified Dividends, which are subject to a lower level of taxation, provided that the investor held the shares in the company for a minimum holding period prior to the ex-dividend date. The maximum ordinary dividend tax is 39.6% and the maximum qualified dividend tax is 20%.<sup>27</sup>

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<sup>24</sup> U.S. CONST. ART. I § 8.

<sup>25</sup> Internal Revenue Service, *2014 Instructions for Form 1120*, Ctat. No. 11455T (Jan. 8, 2015).

<sup>26</sup> For the purposes of discussion all references to “Person” or “person” unless specified as applying only to “natural person(s)” shall mean an individual, a trust, estate, partnership, agency, branch or corporation organized or incorporated under the laws of the relevant jurisdiction.

<sup>27</sup> *Tax Law Changes for 2008*, KIPLINGER’S (2009), [http://www.kiplinger.com/features/archives/2008/11/tax-planning-tax-law-changes4.html?kipad\\_id=44](http://www.kiplinger.com/features/archives/2008/11/tax-planning-tax-law-changes4.html?kipad_id=44) (last visited Jun 20, 2017); *Supra* note 19. Qualified Dividends must (a) be paid after December 31, 2002, by (i) a U.S corporation, (ii) a foreign corporation located in a jurisdiction subject to a U.S. tax treaty or (iii) on stock in a foreign corporation traded on a U.S. exchange by way of an American Depository Receipt (A.D.R.), and (b) the stock must have been held by the investor for more than 60 out of the 121 days preceeding the ex-dividend date.

## III. SURVEY OF LOW TAX JURISDICTIONS

The nominal corporate tax rate, although a significant consideration in tax planning, is often neither the central operative factor in a tax planning strategy for a multinational corporation nor is it a business driver. Instead it is more often the special tax treatment of certain types of income in a certain jurisdiction that plays a major factor. However, it is important in understanding basic structures to evaluate the nominal rate of a jurisdiction to provide a baseline for understanding the tax efficiency of the given strategy.

<u>High Tax</u>	<u>Medium-High</u>	<u>Medium-Low</u>	<u>Low Tax</u>	<u>No Tax</u>
Japan (33.06%)	Australia (30%)	China (25%)	Bulgaria (10%)	British Virgin Islands
USA (40%)	Brazil (34%)	Hungary (19%)	Cyprus (12.5%)	Cayman Islands
	Canada (26.5%)	Poland (19%)	Ireland (12.5%)	Estonia
	France (33.33%)	Romania (16%)	Latvia (15%)	Jersey
	Germany (29.65%)	Russia (20%)	Netherlands (25%)	UAE <sup>28</sup>
	India (34.61%)	Slovenia (17%)	Switzerland (17.92%)	
	Malta (35%)	UK (20%)		
	Spain (28%)			

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<sup>28</sup> Tax tools & resources, KPMG, <http://www.kpmg.com/Global/en/services/Tax/tax-tools-and-resources/Pages/corporate-tax-rates-table.aspx> (last visited Jun 20, 2017).

## IV. PAST: TRADITIONAL TAX STRUCTURES

## A. Limited Liability Companies and Corporations

As a preamble to understanding basic holding structures, it is important to understand the tax distinction in business entity types and how tax rules evolved organically to permit these types of arrangements. For tax purposes, most places in the world classify business entities into two types: pass-through or disregarded entities, and entities with a corporate personality; the two most common American varieties being the Limited Liability Company<sup>29</sup> and the Corporation, respectively.<sup>30</sup> These types of forms have an equivalent structure in most jurisdictions, for example, in Switzerland and Germany the *Gesellschaft mit beschränkter Haftung (GmbH)*<sup>31</sup> (Farlex) and *Aktiengesellschaft (AG)*.<sup>32</sup>

The primary feature shared by both Limited Liability Companies and Corporations is “Limited liability.”

Limited liability is a type of liability that does not exceed the amount invested in a partnership or limited liability company. The limited liability feature is one of the biggest advantages of investing in publicly listed companies. While a shareholder can participate wholly in the growth of a company, his or her liability is restricted to the amount of the investment in the company, even if it subsequently goes bankrupt and racks up millions or billions in liabilities.

In a partnership, the limited partners have limited liability, while the general partner has unlimited liability. The limited liability feature protects the investor's or partner's personal assets from the

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<sup>29</sup> *Small Business/Self-Employed Topics, Limited Liability Company (LLC)*, INTERNAL REVENUE SERVICE, <https://www.irs.gov/businesses/small-businesses-self-employed/limited-liability-company-llc> (last visited Jun 20, 2017).

<sup>30</sup> *Id.*

<sup>31</sup> *The Free Dictionary*, GMBH, <http://acronyms.thefreedictionary.com/GmbH> (last visited Jun 26, 2015).

<sup>32</sup> *The Free Dictionary*, AKTIENGESELLSCHAFT, <http://financial-dictionary.thefreedictionary.com/Aktiengesellschaft> (last visited Jun 24, 2015).

risk of being seized to satisfy creditor claims in the event of the company's or partnership's insolvency.<sup>33</sup>

Civil Law jurisdictions generally have differing capitalization requirements for the Limited Liability Company versus the Corporation. The Italian *Società per azioni* (*S.p.A.*) for example carries an initial capitalization requirement of €50,000. Like an *AG* or Corporation, the capital is split amongst the shares “*azioni*” that can be transferred by endorsement or bought and sold on a stock exchange. In Italy, only an *SpA* can be quoted in a stock exchange, issue corporate bonds, and other financial instruments.<sup>34</sup> The *SpA* is also the required form for protected businesses such as banks, leasing companies, etc. The Italian Civil Code also provides for the *Società a responsabilità limitata* (*Srl*). An *Srl* has a lesser initial capitalization requirement of €10,000. Like a Limited Liability Company or *GmbH*, in an *SrL* capital is split into stakes “*quote*” which can be traded by notarial act in Civil Law countries or by Contract in Common Law Countries. In the United States for example, no notarial act is required for the transfer of shares.<sup>35</sup> As in an Italian *SrL*, a United States Limited Liability Company traditionally could not be listed on most public exchanges including the New York Stock Exchange or NASDAQ because of the added uncertainty associated with a Limited Liability Company by virtue of its “Operating Agreement.” According to Black’s Law Dictionary, an LLC Operating Agreement is:

[A] document that customizes the terms of a Limited Liability Company (LLC) according to the specific needs of the owners, and outlines the financial and functional decision-making in a structured manner. Though writing an Operating Agreement is not a mandatory requirement for most states, it is

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<sup>33</sup> *Limited Liability*, INVESTOPEDIA, <http://www.investopedia.com/terms/l/limitedliability.asp#ixzz3fhHLZ1Vn> (last visited Jun 26, 2015); *supra* note 15.

<sup>34</sup> Italian Civil Code of 1942 (as amended by Government Act 6/2003).

<sup>35</sup> Gesuato Elisabetta, *La S.p.A. si costituisce con capitale minimo di 50.000 €, FISCO E TASSE* (July 3, 2014), <https://www.fiscoetasse.com/approfondimenti/11929-la-spa-si-costituisce-con-capitale-minimo-di-50-000.html> (last visited June 25, 2015).



nonetheless considered a crucial document that should be included when setting up a Limited Liability Company. The document, once signed by the members (owners), acts as a binding set of rules for them to adhere. The document is drafted to allow owners to govern the internal operations according to their own rules and specifications.<sup>36</sup>

These provisions fill in for state law, which would govern a Corporation. In popular states for corporate formations like Delaware, the body of law is well developed and provides a level playing field for prospective investors.<sup>37</sup> Traditionally the uncertainty associated with varying terms in LLC operating agreements could not be overcome by the rather substantial tax benefits a Limited Liability Company could sustain through the elimination of double-taxation. However, so called “widely held partnerships” or “publicly traded partnerships” (“PTPs”) have become more of a reality; specifically in oil, gas and natural resource projects. The rise of PTPs lead to the implementation of rules that cause these types of entities to be treated as corporations by the United States Internal Revenue Service in most instances.<sup>38</sup>

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<sup>36</sup> *LLC Operating Agreement*, INVESTOPEDIA <http://www.investopedia.com/terms/l/llc-operating-agreement.asp> (last visited June 26, 2015); *How To Change Ownership Of A Limited Liability Company*, THE LAW DICTIONARY, <http://thelawdictionary.org/article/how-to-change-ownership-of-a-limited-liability-company/> (last visited Jun 26, 2015).

<sup>37</sup> *Facts and Myths*, STATE OF DELAWARE [http://corplaw.delaware.gov/eng/facts\\_myths.shtml](http://corplaw.delaware.gov/eng/facts_myths.shtml) (last visited June 26, 2015).

<sup>38</sup> Daniel M Dunn, Michael Hirschfield & Michael A Lehmann, *Publicly traded partnership proposed regulations*, LEXOLOGY (2015), [http://www.lexology.com/library/detail.aspx?g=0af9fa15-9a54-40ea-ad4d-ac780edfe247&utm\\_source=Lexology%2BDaily%2BNewsfeed&utm\\_medium=HTML%2Bemail%2B-%2BBbody%2B-%2BGeneral%2Bsection&utm\\_campaign=Lexology%2Bsubscriber%2Bdaily%2Bfeed&utm\\_content=Lexology%2BDaily%2BNewsfeed%2B2015-06-25&utm\\_term](http://www.lexology.com/library/detail.aspx?g=0af9fa15-9a54-40ea-ad4d-ac780edfe247&utm_source=Lexology%2BDaily%2BNewsfeed&utm_medium=HTML%2Bemail%2B-%2BBbody%2B-%2BGeneral%2Bsection&utm_campaign=Lexology%2Bsubscriber%2Bdaily%2Bfeed&utm_content=Lexology%2BDaily%2BNewsfeed%2B2015-06-25&utm_term) (last visited Jun 26, 2015); *Internal Revenue Bulletin: 2015-21, Notice of Proposed Rulemaking Qualifying Income from Activities of Publicly Traded Partnerships With Respect to Minerals or Natural Resources*, INTERNAL REVENUE SERVICE (May 26, 2015), [http://www.irs.gov/irb/2015-21\\_IRB/ar14.html](http://www.irs.gov/irb/2015-21_IRB/ar14.html) (last visited June 26, 2015).

The elimination of double-taxation is the largest tax distinction between a Corporation and a Limited Liability Company. The Limited Liability Company is treated by default as a pass-through or “disregarded” entity, which means that the profits and losses flow through the entity as if the owners had engaged in those activities personally. The Corporation on the other hand is treated as a “person” which is subject to taxation independent of its shareholders on the basis of a corporate income tax and its shareholders are subject to a second tax when the profits of the corporation are distributed in the form of a dividend.<sup>39</sup>

## B. Basic Holding Structures

### 1. *Reduction of Withholding Taxes*

Consider the following scenario. Investors in Sweden invest in an active operating company in Canada that manufactures cars. The Canadian company is a corporation for the purposes of the Canadian Revenue Code and thus taxed at 26.5%.<sup>40</sup> The company retains a small amount in reserves and distributes the remainder of its profits to the Swedish company in the form of a dividend. Pursuant to subsection 215(1) of the *Canadian Income Tax Act*, dividends to non-resident shareholders would normally be taxed at a rate of 25% to be withheld and paid to the Canadian Revenue Authority. However, because of the *Canada-Sweden Tax Treaty*, the Canadian company would only be required to apply the reduced rate of 15%.

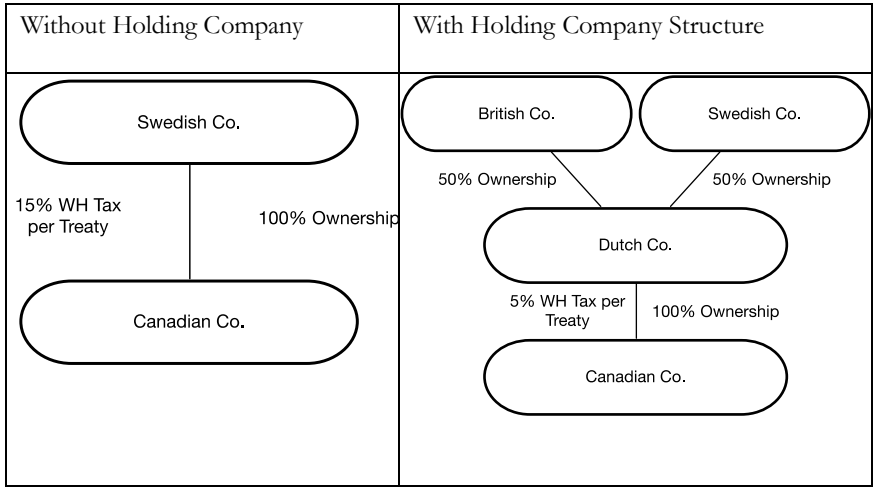
Consider now that the Swedish company takes on a partner in the United Kingdom and this partner desires to invest into 50% of the shares of the Canadian company. If the British company acquired 50% of the shares of the Canadian company directly, it would be subject to a reduced rate of taxation of 10% pursuant to the *Canada-United Kingdom Tax Treaty*. However, the Swedish company and the

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<sup>39</sup> *Classification of Taxpayers for U.S. Tax Purposes*, INTERNAL REVENUE SERVICE, <https://www.irs.gov/individuals/international-taxpayers/classification-of-taxpayers-for-u-s-tax-purposes> (last visited Jun 26, 2015); *Limited Liability Company (LLC)*, INTERNAL REVENUE SERVICE, <https://www.irs.gov/businesses/small-businesses-self-employed/limited-liability-company-llc> (last visited June 26, 2015); *supra* note 29.

<sup>40</sup> *Id.*

British company decide instead to form a jointly-owned subsidiary holding company that will own the Canadian company. This company would be formed in the Netherlands and consist merely of a post office box and have no employees. The Swedish and British companies agree as shareholders to pay 80% of all profits of the Dutch company to the Swedish and British shareholders by way of a dividend. Thus, the applicable tax treaties would become the *Canada-Netherlands Tax Treaty*, which provides for a reduced rate of 5%. The Dutch company is not subject to Income Tax on the foreign dividends received and Dutch law provides for certain credits reducing the tax on re-distributed dividends which originate from dividends received from other countries reducing the Dutch tax to virtually zero.<sup>41</sup>



<sup>41</sup> Joseph Peters, Netherlands: A Dutch Tax Credit For Foreign Dividend W/H Tax, Even Though The Dividend Received Is Not Taxed In The Netherlands, Due To The Dutch Participation Exemption, MONDAQ (2013), <http://www.mondaq.com/x/228050/Corporate+Tax/A+Dutch+Tax+Credit+For+Foreign+Dividend+WH+Tax+Even+Though+The+Dividend+Received+Is+Not+Taxed+In+The+Netherlands+Due+To+The+Dutch+Participation+Exemption> (last visited Jun 7, 2015); Dutch withholding taxes on outbound payments, TAX CONSULTANTS INTERNATIONAL, [https://www.tax-consultants-international.com/read/Dutch\\_withholding\\_taxes](https://www.tax-consultants-international.com/read/Dutch_withholding_taxes) (last visited Jun 7, 2015); Dentons, Landmark treaty case: Prévost Car Inc. v. The Queen, LEXOLOGY, <http://www.lexology.com/library/detail.aspx?g=50700034-20f4-4677-826b-a36d4ee3923e> (last visited June 20, 2017); 2008 TCC 231 (CanLII), *Prevost Car Inc. v. The Queen*, <http://canlii.ca/t/lwpfq> (last visited June 7, 2015).

Thus by shifting profits from Canada through a Dutch Holding Company, the result is that the total effective tax on the dividends can be reduced from 25% assuming no treaty is in place to approximately 5%. These types of structures have been subject to attack by revenue-losing governments. Many governments have put into play “substance requirements,” which require that the entity have some purpose and basic existence in the host country other than mere incorporation.

The *OECD Model Treaty* and the *Canada-Netherlands Tax Treaty* also contain provisions in Article 10, Section 2 which made the treaty benefits only applicable if the person was the “beneficial owner,” to wit: “if the recipient is the beneficial owner of the dividends the tax so charged shall not exceed . . . .” However, this scenario was based upon a 2008 Canadian case in which the Canadian Revenue authority had ruled that the Dutch company was not the “beneficial owner” of the dividend and that the term “beneficial owner” is in fact not defined anywhere in the treaties.<sup>42</sup> This is inapposite to the UK High Court’s finding in the case of *Indofood International Finance Ltd. V. JPMorgan Chase Bank, London Branch*. In *Indofood*, the English High Court held “that a newly interposed Dutch company used purely to take advantage of the treaty would not be the beneficial owner of the interest and, therefore, the purported tax objective of any theoretical restructuring to avoid the 20% withholding would not be effective”.<sup>43</sup> Contrarily in *Prevost*, in rendering the Court’s decision, Justice Rip held that *Indofood* was distinctive from *Prevost* because in *Indofood*, there was no discretion left to any party as to whether income could be passed through the structure making the Dutch company merely a “conduit.” Alternatively, in *Prevost*, the Dutch company was not bound by its articles of formation to make a subsequent dividend payment to the UK Company and the Swedish Company. The Swedish and UK Companies did in fact however have a side agreement to which the Dutch company was not a party agreeing to

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<sup>42</sup> *Id.*

<sup>43</sup> *Indofood Decision: UK Tax Authorities' Guidance on Treaty Claim*, (Oct 23, 2006), <https://www.clearygottlieb.com/news-and-insights/publication-listing/indofood-decision--uk-tax-authorities--guidance-on-treaty-claims9> (last visited June 28, 2015)

vote in favor of at least an 80% dividend. Justice Rip determined that because the Dutch company was not a party to the side agreement the remedies for failure to issue a dividend would be decided in litigation amongst the shareholders directly and not by suing the Dutch company. The Court held this distinction sufficient to distinguish the facts before it from *Indofood* in finding that the Dutch company was in fact the beneficial owner of the dividends issued by the Canadian company for the purposes of treaty benefits.<sup>44</sup>

The tax imposed by Canada on the Dutch company is what is known as “inbound” taxation, while the tax imposed by Holland on the Dutch company’s dividends paid to foreign entities is what is known as “outbound” taxation. Each term is so defined based upon the direction of the movement of capital. This example is not the end of the story with respect to what Governments are doing to limit these types of structures. Substance Requirements and CFC Rules will be further addressed in Article V.

## 2. *Protection from Local Capital Gains Taxation*

Taxation on income from operations of a business is taxed as ordinary income at the applicable rate for that business. As discussed *supra* at Ch. III, Art. A, such income is either taxed at the corporate level applying the applicable corporate income tax rate or at the level of the individual owners in the case of a pass-through entity like a Limited Liability Company. When a person engages in investment into a capital asset, such as an investment or real estate that:

gives it a higher worth than the purchase price. The gain is not realized until the asset is sold. A capital gain may be a short term (one year or less) or long term (more than one year) and must be claimed on income taxes. A capital loss is incurred when there is a decrease in the capital asset value compared to an asset’s purchase price.<sup>45</sup>

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<sup>44</sup> 2008 TCC 231, *supra* note 41.

<sup>45</sup> Investopedia, *Capital Gain*, <http://www.investopedia.com/terms/c/capitalgain.asp> (last visited June 1, 2015); *supra* note 15.

In Ch. 1 Art. 2 *supra* we analyzed the Qualified vs. Ordinary dividend tax rates in the United States. These rates are mimicked by the rates imposed for Long-Term Capital Gain and Short-Term Capital Gain taxes. Long-Term Capital Gains are capital gains on assets which are held for longer than one-year. These types of capital gains are subject to taxation at the lesser amount of 20% for most types of transactions.<sup>46</sup>

These types of capital gains are particularly applicable to investment companies and private equity funds which trade assets regularly. Private equity funds typically have a longer horizon for their investments and hold them for longer than a year making most of their income subject to long-term capital gains tax. Moreover, private equity funds are typically structured as pass-through entities and its managers are paid by receiving a share of the profits, thus receiving the vast majority of their compensation in capital-gains and subject to a lesser tax than the 40% they would otherwise be subject to at normal U.S. personal income tax rates.<sup>47</sup>

The OECD conducted a survey of Long-Term Capital Gains taxation by country in 2011, resulting in the following with a few additions for discussion purposes:<sup>48</sup>

<u>High Tax</u>	<u>Medium-High</u>	<u>Medium-Low</u>	<u>Low Tax</u>	<u>No Tax</u>
Italy (44.5%)	Norway (28%)	United States (19.1%)	Japan (10%)	Mexico
Denmark (42%)	Germany (25%)	Israel (20%)	Hungary (16%)	Luxembourg
France (31.3%)	Finland (28%)	Estonia (21%)		Portugal

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<sup>46</sup> Internal Revenue Service, *Topic 409 Capital Gains and Losses*, <https://www.irs.gov/taxtopics/tc409.html> (last visited June 1, 2015).

<sup>47</sup> MARK JICKLING & DONALD MARPLES, *TAXATION OF HEDGE FUND AND PRIVATE EQUITY MANAGERS* (2014).

<sup>48</sup> Robert Carroll & Gerald Prante, *Corporate Dividend and Capital Gains Taxation: A comparison of the United States to other developed nations*, (2012), [http://www.theasi.org/assets/EY\\_ASI\\_Dividend\\_and\\_Capital\\_Gains\\_International\\_Comparison\\_Report\\_2012-02-03.pdf](http://www.theasi.org/assets/EY_ASI_Dividend_and_Capital_Gains_International_Comparison_Report_2012-02-03.pdf) (last visited June 25, 2015)

Sweden (30%)	UK (28%)	Iceland (20%)		Austria
	Australia (22.5%)	Poland (19%)		Netherlands
	Spain (21%)	Slovak Republic (19%)		Korea
	Canada (22.54%)	Chile (20%)		Switzerland
	Ireland (25%)			Greece
				Slovenia
				Turkey
				Czech Republic
				Cayman Islands <sup>49</sup>
				Bermuda <sup>50</sup>
				Mauritius <sup>51</sup>

The OECD model convention addresses Capital Gains in Article 13, which provides the following in substance:

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<sup>49</sup> Cayman Island Government, *Taxes*, (2011), <http://www.gov.ky/portal/page/portal/cighome/cayman/theeconomy/taxes> (last visited June 24, 2015).

<sup>50</sup> Trading Economics, *Bermuda Corporate Tax Rate*, <https://tradingeconomics.com/bermuda/corporate-tax-rate> (last visited Jul 22, 2017).

<sup>51</sup> Gary Gowrea, *Standard Chartered – Publicised tax avoidance strategy*, ACTIONAID (Jan. 2015), [http://www.actionaid.org/sites/files/actionaid/standard\\_chartered-\\_publicised\\_tax\\_avoidance\\_strategy\\_0.pdf](http://www.actionaid.org/sites/files/actionaid/standard_chartered-_publicised_tax_avoidance_strategy_0.pdf) (last visited June, 25 2015)

1. Gains derived by a resident of a State A from alienation of immovable property State B may be taxed in State B.
2. Gains derived by resident of State A forming part of the “business property of a permanent establishment” which an enterprise of State A has in State B, including gains from the alienation of the permanent establishment itself may be taxed in State B.
3. Gains from the alienation of ships or aircraft operated in international traffic, or movable property pertaining to the operation of ships, aircraft or boats shall be taxed in the state “where place of effective management is situated.”
4. Gains derived by resident of State A from alienation of shares deriving more than “50 per cent of their value directly or indirectly from immovable property” situated in State B may be taxed in State B.
5. All other gains than in Paragraphs 1-4 shall be taxable only in the state where the alienator is a resident.<sup>52</sup>

Consider the following scenario. A Chinese company wishes to invest in a Mozambique Company that holds immovable property in Mozambique. Pursuant to Mozambique law capital gains are taxed at a rate of 32%. In 2014, Texas-based Andarko, an oil and gas company paid Mozambique \$520 million USD in capital gains after a transaction yielded a capital gain of \$1.625 billion USD.

Instead, if the Chinese company interposes a holding company in Mauritius that owns 100% of the shares in the

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<sup>52</sup> *Supra* note 7.



Mozambique Co., the capital gains tax can be eliminated per the tax treaty between Mauritius and Mozambique, which states to wit:

Mauritius has the exclusive right to tax any gains derived by the Mauritius Holding Company on the sale of shares held in the Mozambique Company.

As opposed to other tax treaties signed by Mozambique, Mauritius has exclusive rights to tax capital gains on the sale of shares held in the Mozambique Company even if the assets of the Mozambique Company consist (sic) principally of immovable property.<sup>53</sup>

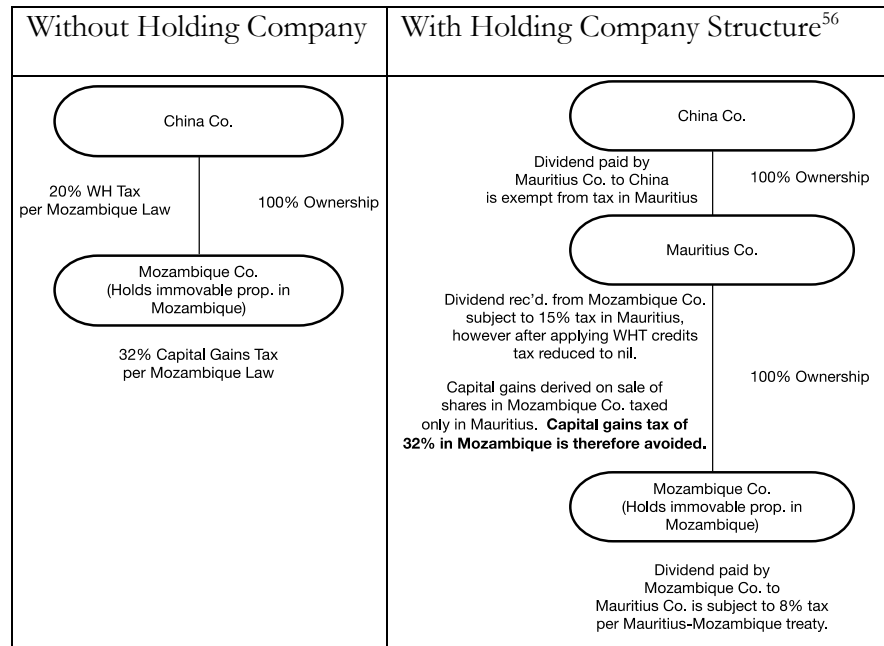
“As per the tax treaty between Mauritius and Mozambique, dividend [sic] paid to the Mauritius Holding Company will be subject to a reduced withholding tax rate of 8% in Mozambique.”<sup>54</sup> Capital Gains are also not taxed in Mauritius on this type of transaction because the Mauritius-Mozambique double taxation treaty excludes Paragraph 4 of the Model Convention applying to immovable property, thus pushing this transaction into the catchall Article 13, Paragraph 5 of the OECD Model Convention.<sup>55</sup>

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<sup>53</sup> *Supra* note 51.

<sup>54</sup> Gary Gowrea, *Mauritius: Investment Gateway to Africa* in *Maximising Business Opportunities in Asia, Africa and the Middle East – a Treasury Guide*, CIM TAX SERVICES (2014), [https://www.cim.mu/files/cgb/mauritius%20-%20investment%20gateway%20to%20africa%20\(insights%20201314\)%20a%20publication%20of%20standard%20chartered%20bank.pdf](https://www.cim.mu/files/cgb/mauritius%20-%20investment%20gateway%20to%20africa%20(insights%20201314)%20a%20publication%20of%20standard%20chartered%20bank.pdf) (last visited June 21, 2017).

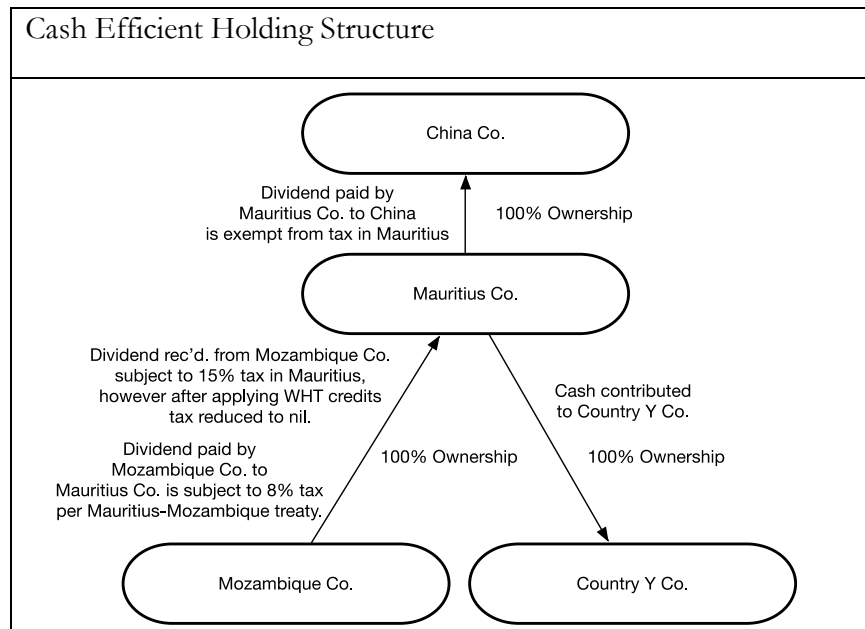
<sup>55</sup> *Supra* 53; *Agreement between the Republic of Mauritius and the Republic of Mozambique for the Avoidance of Double Taxation with Respect to Taxes on Income*, LEGAL SUPPLEMENT TO THE GOVERNMENT GAZETTE OF MAURITIUS (1997).



### 3. *Tax Efficient Movement of Cash*

A major consideration of any business with operating entities in foreign jurisdictions is how to get cash to those entities without suffering a debilitating tax. Consider the previous scenario. Investor parent company in China invests in an Operating Company in Mauritius, but now also invests in another Operating Company in Country Y. The Chinese company wants a way to move cash easily into the Operating Company in Country Y. As discussed *supra*, dividends paid would be subject to a 20% withholding tax in Mozambique, thus limiting the capital available for movement from China to Country Y.

<sup>56</sup> *Supra* note 52.



Using a similar structure, the Chinese investors would interpose Country Y's Operating Company as a wholly owned subsidiary of the Mauritius Co. subject to the same reduced 8% withholding tax.<sup>57</sup> However, instead of the Mauritius Co. redistributing the dividend to China it would make a capital investment either as equity or debt into Country Y's Operating Company.

### C. Financing Structures

Another reason that companies develop holding structures is for tax efficient financing. In financing structures, the primary driver is often not tax efficiency, but rather non-tax considerations like the availability of external financing sources. Tax only becomes the bigger consideration when internal financing is proposed (e.g., the Holding Co. lending to the Operating Co. or CFC 1 lending to CFC 2).

<sup>57</sup> *Id.*

As discussed *infra* Article IV, Section D, Chapter 4 (the Amazon.com, Hybrid and Reverse Hybrid examples), lending internally is an effective way of reducing income in a high-tax country and shifting it to a low-tax country. Some basic financing structures apply in this regard.

1. *Spain – Swiss Finance Branch*

Consider the following scenario:

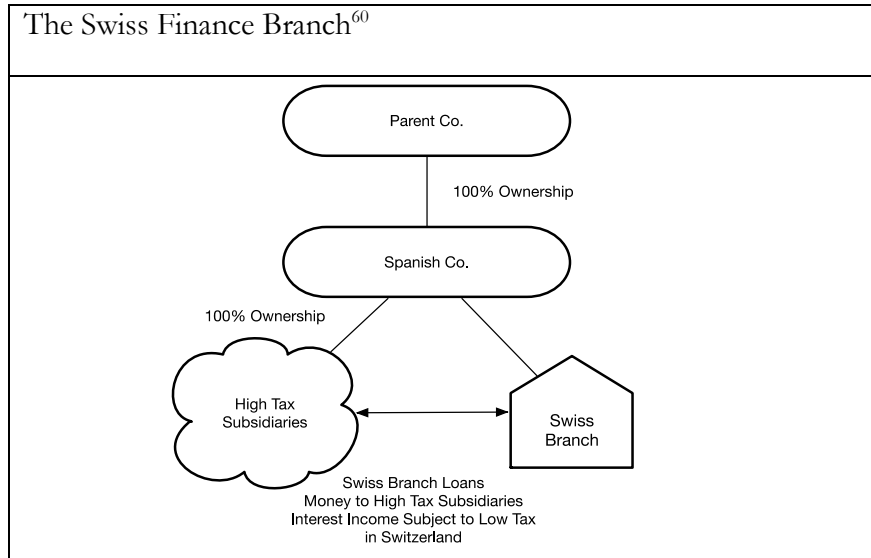
1. ParentCo. in High-Tax Jurisdiction owns Spanish Co., which is a corporate subsidiary.
2. Spanish Co. owns subsidiaries in high-tax jurisdictions.
3. Spanish Co. establishes a branch office in Switzerland.
4. The Swiss Branch loans money to the high-tax subsidiaries for operating capital and the interest is sufficient to wipe-out the profits of the subsidiaries in the high-tax countries.
5. Pursuant to Swiss Law, the branch is subject to a low-level of taxation in Switzerland on interest income and no withholding tax on profits redistributed to the Spanish head office, because the branch is a disregarded or non-existent entity.<sup>58</sup>
6. Pursuant to Spanish law there is no deemed interest income in Spain so the interest income is tax exempt in Spain.<sup>59</sup>

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<sup>58</sup> Corporate Taxation System In Switzerland, INT'L TAX REV. (2015), [http://www.internationaltaxreview.com/pdfs/taxdata/tax\\_data\\_switzerland\\_000226.pdf](http://www.internationaltaxreview.com/pdfs/taxdata/tax_data_switzerland_000226.pdf) (last visited July 6, 2015).

<sup>59</sup> Barbra Mambrilla & Jose Manuel Calderon, *The new Tax Protocol to the Spain-Switzerland Tax Treaty*, GOMEZ-ACEBO & POMBO (Feb. 2013), <http://www.gomezacebo-pombo.com/media/k2/attachments/the-new-tax-protocol-to-the-spain-switzerland-tax-treaty.pdf> (last visited July 6, 2015).

7. The end-result is a deferral strategy whereby the profits are shifted from the high-tax subsidiaries to the Swiss Branch.
8. The effectiveness of this strategy is subject to avoidance of Spanish CFC legislation, which is discussed *infra* in Article IV, Section D, Chapter 2.



## 2. Malta Financing Structure

Consider the following scenario:

1. Parent Co. in high-tax jurisdiction owns Malta Co., a Maltese subsidiary company.
2. Malta taxes interest income at a low rate.
3. Malta Co. loans money to the subsidiaries of Parent Co. in high tax jurisdictions.
4. The high tax companies get the interest deduction.

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<sup>60</sup> Madeleine Syré, MODULE 6 – M&A - TAX PLANNING (2014), University of St. Gallen, EMBL-HSG.

5. The interest is initially taxed at 35% in Malta.<sup>61</sup>
6. The money is distributed by the Malta Co to the Parent Co. in the form of a dividend and subject to no withholding tax pursuant to Maltese law.<sup>62</sup>
7. Under Maltese law, interest income is classified as “Passive Interest” if the interest income is not derived, directly or indirectly, from a trade or business and the interest income has not suffered or has suffered foreign tax of less than 5%. “Then a registered shareholder of a Malta company who has: (i) received a dividend from a Malta company, from (ii) profits of the company which arise from Passive Interest, is entitled to claim a 5/7<sup>th</sup>s refund of the CIT paid by the Malta company on the Passive Interest.”<sup>63</sup> If the income is not “Passive Interest” the fallback is that the interest is classified as “Non-Passive Interest” an subject to a 6/7<sup>th</sup>s refund of the CIT paid by the Malta company on the interest.<sup>64</sup>
8. The effectiveness of this strategy is subject to avoidance of CFC legislation in the high-tax country, which is analyzed in detail in Section D, however it is likely given the fact that the tax is charged and a refund paid, that double-taxation treaty benefits would likely be available to the Parent Co. for the taxes paid in Malta at 35%.

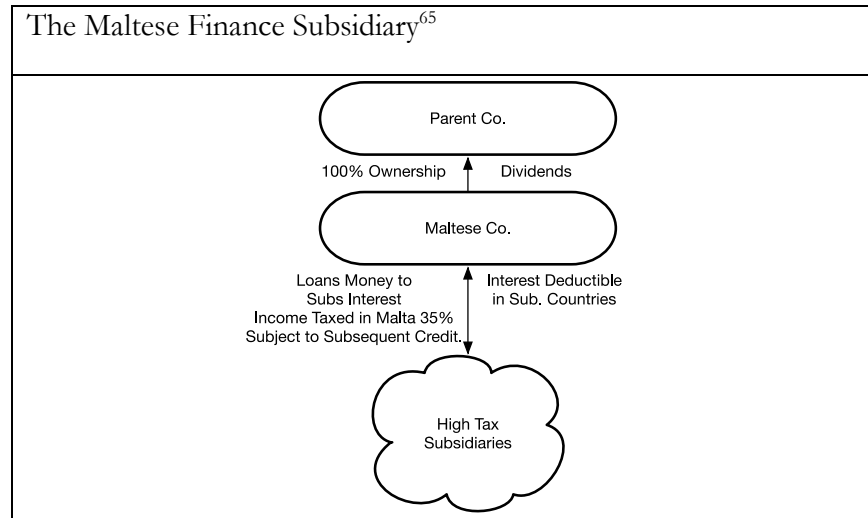
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<sup>61</sup> Jonathan Pisani, *Taxation of interest income*, CHETCUTI CAUCHI ADVISORS (May 23, 2012), [https://www.ccmalta.com/publications/taxation\\_of\\_interest\\_income](https://www.ccmalta.com/publications/taxation_of_interest_income) (last visited Jul 6, 2015).

<sup>62</sup> Nicholas Gouder, *Malta: Withholding Taxes*, MONDAQ (Oct. 1, 2013), <http://www.mondaq.com/x/266212/withholding%20tax/Malta%20Withholding%20Taxes> (last visited Jul 6, 2015).

<sup>63</sup> *Supra* note 61.

<sup>64</sup> *Id.*



3. *Malta – BeNeLux Interest Free Loan with Notional Interest Deduction (“NID”)*

Consider the following scenario:

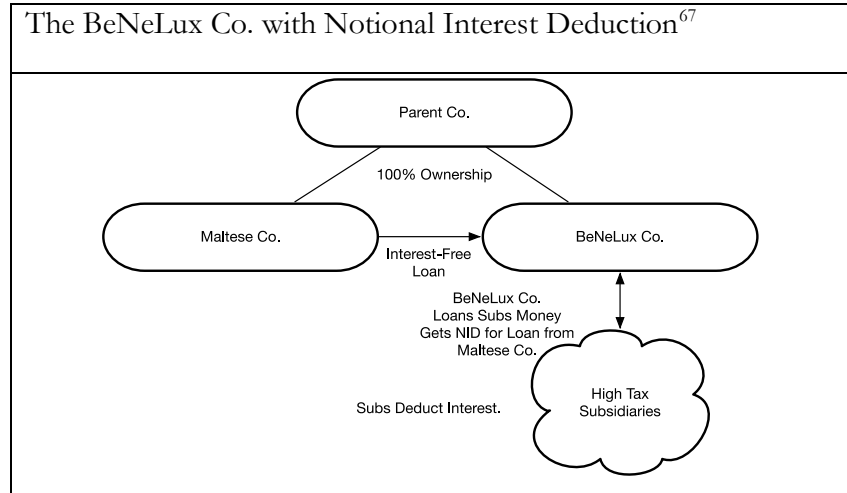
1. Parent Co. in high-tax jurisdiction owns Malta Co., a Maltese subsidiary company and BeNeLux Co., a Belgian subsidiary company.
2. Parent Co. makes an equity contribution to Malta Co.
3. Malta Co. makes an interest free loan to BeNeLux Co.
4. BeNeLux Co. makes a loan to OpCo in a high tax jurisdiction.
5. OpCo deducts the interest paid to BeNeLux Co.
6. BeNeLux Co. receives a “Notional Interest Deduction” equal to the amount of Belgium’s published rates. “The deduction for risk capital or more commonly called “notional interest deduction” (NID) is a unique tax

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<sup>65</sup> *Supra* note 60.

measure allowing a tax-free return on qualified equity by allowing a deemed interest deduction calculated as the qualifying equity multiplied by the applicable NID rate”.<sup>66</sup>

7. This creates a tax deferred cash accumulation in BeNeLux Co. and only principal amounts remain owing to Malta Co.



#### 4. Finance Structures Do Not Drive Business Substantively

In evaluating structures both in the context of treaty application and financing structures, the question of whether or not tax is a business driver is ever present. Choosing where to establish a mailbox company and where to loan money for the purposes of deductions like the Notional Interest Deduction are strategies that haven't truly driven business in a measurable way. These are tactics that allow business to function in more tax efficient ways, but do not introduce new lines of business or otherwise drive business out of a market. The end result is ultimately the same, profits are drained from high-tax subsidiaries into low-tax countries. That does not

<sup>66</sup> *What NID Could Mean for Your Company's Effective Tax Rate*, ERNST & YOUNG (2015), [http://www.ey.com/Publication/vwLUAssets/Notional\\_Intrest\\_Deduction\\_2011/\\$FILE/NID%202011.pdf](http://www.ey.com/Publication/vwLUAssets/Notional_Intrest_Deduction_2011/$FILE/NID%202011.pdf) (last visited July 6, 2015)

<sup>67</sup> *Supra* note 60.



mean that the company has truly ceased any operations in those jurisdictions.

#### D. Multinational Corporations

##### 1. *International vs. Intra-Europe*

Across the world companies have applied the disparate treatment of tax available from various double taxation treaties to their business model to create holding structures that are tax efficient both for the purposes of driving the bottom line and efficiently moving cash between subsidiaries. However, companies also have additional rules which apply to their activities when those activities take place within the European Internal Market. Two major European Union directives apply, they are the E.U. Parent/Subsidiary Directive and the E.U. Interest and Royalty Directive.

Article 31 EEA provides in relevant part that:

[T]here shall be no restrictions on the freedom of establishment of nationals of an EC Member State or an EFTA State in the territory of any other state of these States. This shall also apply to the setting up of agencies, branches or subsidiaries by nationals of any EC Member State or EFTA State established in the territory of any of these states.<sup>68</sup>

The language of Article 34 of the EEA (like Article 54 of the Treaty on the Functioning of the European Union) provides that:

Companies or firms ... shall, for the purpose of this Chapter, be treated in the same way as natural persons who are nationals of EC Member States or EFTA States.<sup>69</sup>

In light of this core treaty language, the European Union has taken competence in this area. The E.U. Parent/Subsidiary Directive

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<sup>68</sup> *Supra* note 23 at art. 31.

<sup>69</sup> *Id.* at art. 34.

was adopted on December 22, 2003 “to eliminate tax obstacles in the area of profit distributions between groups of companies in the E.U. by: abolishing withholding taxes on payments of dividends between associated companies of different Member States and preventing double taxation of parent companies on the profits of their subsidiaries”.<sup>70</sup> In sum, this language provides a mechanism that sidesteps the necessity of the holding structure described *supra* in Article IV, Section B.

The E.U. Interest and Royalty Directive was adopted on June 3, 2003 “to eliminate withholding tax obstacles in the area of cross-border interest and royalty payments within a group of companies by abolishing withholding taxes on royalty payments arising in a Member State, and withholding taxes on interest payments arising in a Member State.”<sup>71</sup> In essence, interest and royalty payments arising in one member state are exempt from any taxes in that state if the beneficial owner of the payment is in another member state.<sup>72</sup>

All initial time periods for phased and member-state specific transitional implementation for both directives have passed.<sup>73</sup>

## 2. CFC Rules, United States (Subpart F) and International

The United States tax system is built on two fundamentally inconsistent principles that drive the need for tax structures such as those discussed thus far. These principles are (1) that corporations are treated as independent fictitious persons for the purposes of taxation and (2) that all U.S based taxpayers are subject to worldwide taxation.<sup>74</sup> The tax treatment of corporations was previously

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<sup>70</sup> *Parent companies and their subsidiaries in the European Union*, EUROPEAN COMMISSION, TAXATION AND CUSTOMS UNION, [http://ec.europa.eu/taxation\\_customs/business/company-tax/parent-companies-their-subsidiaries-eu-union\\_en](http://ec.europa.eu/taxation_customs/business/company-tax/parent-companies-their-subsidiaries-eu-union_en) (last visited June 21, 2015).

<sup>71</sup> *Id.*

<sup>72</sup> *Id.*

<sup>73</sup> *Id.*

<sup>74</sup> Office of Tax Policy, *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study*, DEPT. OF THE TREASURY, 1 (Dec. 21, 2000), <https://www.treasury.gov/resource-center/tax-policy/Documents/Report-SubpartF-2000.pdf>.

addressed herein. One distinctive and unique feature of the U.S. tax system is that it taxes all U.S. citizens, residents and corporations on worldwide income.<sup>75</sup> Corporations are determined as U.S. domestic or foreign on the basis of their place of organization contrary to many other places in the world as described herein. Foreign corporations are taxed on income that is from “sources within the United States” or that is “effectively connected with the conduct of a trade or business within the United States”.<sup>76</sup> There is a tension between the two principles insofar as tax Persons are incentivized to use offshore corporations as a barrier to U.S. taxation of the income earned through those corporations.

From 1913 when the U.S. Income Tax was enacted through 1962, a number of tax avoidance techniques were developed by international investors and were subsequently addressed through legislation, including transfers of property to foreign corporations to avoid U.S. tax on the capital gains, the incorporation of the personal or foreign personal holding companies or “incorporated pocketbook” used to hold all personal holdings in stocks bonds or other income producing property and foreign operating and investment companies in the wake of World War II.<sup>77</sup> In 1962, the United States enacted what is known as “subpart F” regulations at I.R.C. §§ 951 – 964.<sup>78</sup>

The Code provides:

[E]very person who is a United States shareholder ... of such corporation and who owns ... stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends . . . . (i) his pro rata share ... of the corporation’s subpart F income for such year[.]<sup>79</sup>

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<sup>75</sup> *Id.* at 2.

<sup>76</sup> *Supra* note 17 at §§ 881 and 882.

<sup>77</sup> *Supra* note 74 at 8.

<sup>78</sup> *Id.* at 12.

<sup>79</sup> *Supra* note 17 at §§ 951.

In summary:

Subpart F applies to certain income of “controlled foreign corporations” (“CFCs”). A CFC is a foreign corporation more than 50% of which, by vote or value, is owned by U.S. persons owning a 10% or greater interest in the corporation by vote (“U.S. shareholders”). “U.S. persons” includes U.S. citizens, residents, corporations, partnerships, trusts and estates. If a CFC has subpart F income, each U.S. shareholder must currently include its pro rata share of that income in its gross income as a deemed dividend.<sup>80</sup>

Subpart F income includes the following:

- **Foreign personal holding company income (FPHCI)**, A major category of subpart F income is foreign personal holding company income (“FPHCI”).<sup>81</sup> (I.R.C. § 954(c)) This category includes interest, dividends and rents and royalties. It also includes gains from the sale of property that produces passive income or that is held for investment, gains from commodities transactions, and gains from foreign currency transactions, as well as certain other income that is, in effect, the equivalent of interest or dividends. Because of its passive nature, such income often is highly mobile and can be easily deflected.<sup>82</sup> . . . . Generally, rents and royalties earned by a CFC in an active business are excluded from FPHCI.<sup>83</sup> This exception does not apply, however, if the CFC’s rents or royalties are received from a related person.
- **Foreign base company sales income** [S]ales income is active income and subpart F generally does not apply to active income. However, certain sales income, referred to as foreign base company sales income (“FBCSP”), is subject to current inclusion under subpart F because, when the manufacturing function is separated from its sales

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<sup>80</sup> *Supra* note 74 at 8-10; *supra* note 17 at §§ 957, 951(b), 957(c), 7701(a)(30), 951(a).

<sup>81</sup> *Supra* note 17 at § 954(c).

<sup>82</sup> *Supra* note 74 at 10.

<sup>83</sup> *Supra* note 17 at § 954(c)(2)(A).

function, the sales income can easily be deflected from the jurisdiction in which the major economic activity that produced the value in the goods occurred, often a high-tax jurisdiction, to a low-tax jurisdiction where the “sales” activities occur.<sup>84</sup> This is particularly true in the case of related party transactions. Thus, the FBCSI rules require current inclusion of income of a CFC from the sale of property (a) that is purchased from, or on behalf of, or sold to, or on behalf of, a related person, and (b) that is manufactured and sold for use, consumption or disposition outside the jurisdiction where the CFC is incorporated.<sup>85</sup>

- **Foreign base company services income** Foreign base company services income is another category of subpart F income that applies to active income that can be deflected to a low-tax jurisdiction through related party transactions, in this case, through the performance of services.<sup>86</sup> Foreign base company services income includes income from services performed outside the CFC's country of incorporation for, or on behalf of, a related person. These rules generally were intended to address circumstances in which service activities are separated from the other business activities of a corporation into a separate subsidiary located in another jurisdiction to obtain a lower rate of tax for the services income.<sup>87</sup>
- **Foreign base company oil-related income** includes income from all oil activities outside the CFC's country of incorporation.<sup>88</sup>
- **Insurance income** includes all income derived from insurance and annuities related to risks that are situated outside the CFC's country of incorporation.<sup>89</sup>

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<sup>84</sup> H.R. Rep. No. 1447, 87th Cong., 2d Sess. 62 (1962) (1962 House Report); S. Rep. No. 1881, 87th Cong., 2d Sess. 84 (1962) (1962 Senate Report).

<sup>85</sup> *Supra* note 17 at § 954(d); *supra* note 74 at xiii.

<sup>86</sup> *Supra* note 17 at § 954(e)(2).

<sup>87</sup> Treas. Reg. § 1.954-4(b)(1)(iv); *supra* note 74 at xiv.

<sup>88</sup> *Supra* note 17 at § 954(g).

All other income earned by a CFC is not subject to U.S. tax until the income is repatriated to the U.S. The United States is no longer alone in implementing CFC rules, however it is alone in its application of worldwide taxation. Although, Germany, Sweden, United Kingdom, Italy, France, Spain, Denmark, Finland and Portugal have enacted CFC regimes that bear some resemblance to the U.S. scheme, the United States has a special provision which permits the creation of what are known as “Hybrid Entities” and arrangements known as “Hybrid Mismatch Arrangements.”<sup>90</sup> A Hybrid Entity is an entity that is taxed as a corporation in a foreign jurisdiction but treated as a partnership or disregarded pass-through entity for U.S. tax purposes. Conversely, a “Reverse Hybrid Entity” is an entity that is taxed as a partnership or disregarded pass-through entity in a foreign jurisdiction and treated as a corporation for U.S. tax purposes.<sup>91</sup> This is a feature of the United States tax code known as Entity Classification Election or “Check the Box.” In order to receive treatment as a corporation or partnership, the eligible entity simply completes IRS Form 8832, which provides the following election:<sup>92</sup>

Form 8832 (Rev. 12-2013) Page 2

**Part I Election Information (Continued)**

**6 Type of entity (see instructions):**

a ☐ A domestic eligible entity electing to be classified as an association taxable as a corporation.

b ☐ A domestic eligible entity electing to be classified as a partnership.

c ☐ A domestic eligible entity with a single owner electing to be disregarded as a separate entity.

d ☐ A foreign eligible entity electing to be classified as an association taxable as a corporation.

e ☐ A foreign eligible entity electing to be classified as a partnership.

f ☐ A foreign eligible entity with a single owner electing to be disregarded as a separate entity.

**7** If the eligible entity is created or organized in a foreign jurisdiction, provide the foreign country of organization ► \_\_\_\_\_

**8** Election is to be effective beginning (month, day, year) (see instructions) . . . . . ► \_\_\_\_\_

**9** Name and title of contact person whom the IRS may call for more information \_\_\_\_\_

**10** Contact person's telephone number \_\_\_\_\_

<sup>89</sup> *Supra* note 17 at § 953.

<sup>90</sup> HRMC's International Manual, *Income and Corporation Taxes Act 1988, as amended (hereafter ICTA88)*, sec. 747 *et seq.*, INTM20000; Inkomstskattelag (1999:1229); §§ 7-14 AStG, Foreign Tax Act; Ernst & Young, *An Overview of CFC Rules in Key EU Countries and an Analysis of Cross-Border Planning Structures to Avoid the Application of CFC Rules*, UNIVERSITÄT HAMBURG, [http://www.m-i-tax.de/content/Wichtige\\_Links/Alumni\\_Netzwerk/documents/cfcrules\\_000.pdf](http://www.m-i-tax.de/content/Wichtige_Links/Alumni_Netzwerk/documents/cfcrules_000.pdf) (last visited July 7, 2015).

<sup>91</sup> *Supra* note 74 at 62.

<sup>92</sup> Form 8832, INTERNAL REVENUE SERVICE, <https://www.irs.gov/pub/irs-pdf/f8832.pdf>.

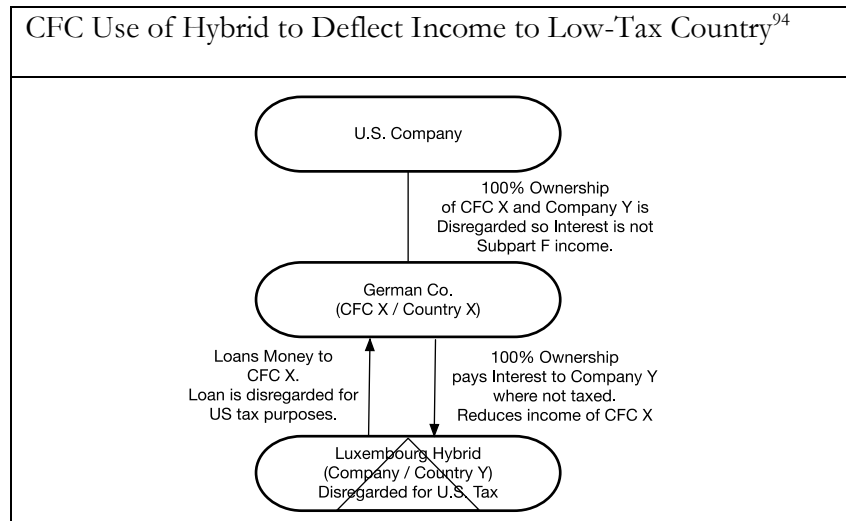
*(i) Scenario: Deflect Profit to Low Tax Country*

Consider the following scenario:

1. Company A is a U.S. company with a wholly owned subsidiary, CFC X in Country X, a high-tax jurisdiction.
2. In order to transfer operating income from CFC X in Country X where it would be taxed at a high rate to Country Y, which is a low-tax country, CFC X creates a wholly owned subsidiary Company Y in Country Y that is treated as a corporation in Country X and of course in Country Y, but would be disregarded for U.S. tax purposes.
3. Company Y makes a loan to CFC X. Country X treats CFC X as a corporation and so the interest payments from CFC X to Company Y are deductible in Country X and thus reduces operating income of CFC X. Interest payments received by Company Y in Country Y, are subject to low-taxation in Country Y.
4. Because the United States treats CFC X as disregarded for U.S. tax purposes, the taxpayer takes the position that interest payments between CFC X and Company Y should be disregarded for U.S. tax purposes and thus should not be considered subpart F income.<sup>93</sup>
5. The end result is that CFC X pays tax significantly reduced income (by the amount of interest paid) in Country X and subject to any applicable double-taxation treaty benefits, tax on equally reduced income in the United States.

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<sup>93</sup> *Supra* note 74 at 64.



*(ii) Scenario: Shelter From Tax in All Jurisdictions*

Now consider an alternative scenario.

1. Company A is a U.S. company with a wholly owned subsidiary, CFC X in Country X, a high-tax jurisdiction.
2. Company A could establish Company X in Country X, the same high-tax jurisdiction, but the entity would not be a corporation, it would be a disregarded pass-through entity, such as a Partnership or Limited Liability Company.
3. Company A would elect to treat Company X as a Corporation for U.S. tax purposes but the law of Country X would provide that the entity would be disregarded for tax purposes.
4. Company A would make a cash contribution to Company X.

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<sup>94</sup> *Id.*

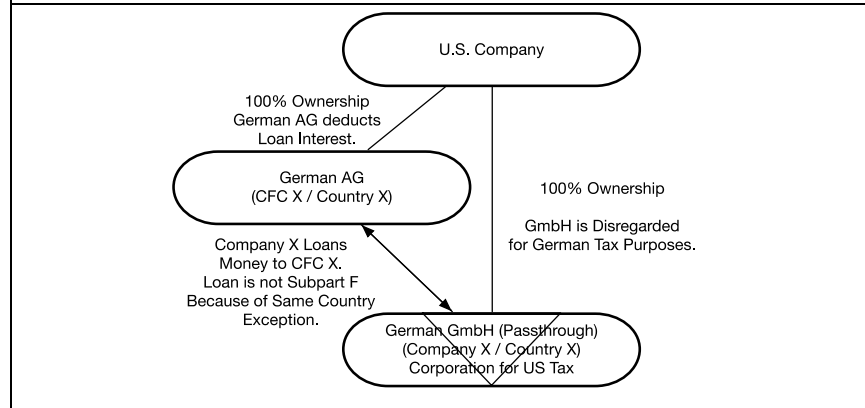


5. Company X would make a loan to CFC X.
6. CFC X would get a deduction in Country X for the interest paid to Company X.
7. For purposes of Country X, Company X is a disregarded entity and no tax would be imposed on Company X for the interest paid to it. Assuming a double taxation treaty existed between Country X and the United States, the interest would likely be subject to minimal withholding tax in Country X.
8. From the United States perspective, the U.S. would treat Company X as a Country X corporation as well as CFC X and thus interest payments between CFC X and Company X would not be subpart F income pursuant to the same country exception in section 954(c)(3)(A)(i) which “exempts from FPHCI dividends and interest received from a related corporation organized under the laws of the same country as the recipient, provided that the related payer corporation has a substantial part of its assets used in a trade or business in the same foreign country.”<sup>95</sup>
9. The end result is CFC X has little or no income for U.S. or Country X tax purposes because it deducts interest paid to Company X. Company X, a disregarded entity pays no tax in Country X because it is disregarded in Country X and no tax in the United States because the U.S. treats it as a Corporation.

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<sup>95</sup> *Id.*

### Use of Reverse Hybrid to Shelter Income from Tax in All Jurisdictions<sup>1</sup>



This is of course, as in the first example, a tax deferral strategy as compared to an avoidance strategy. Whenever Company X in this example or Company Y in the prior example repatriates profits to the U.S. Company, these profits would be subject to taxation as dividends pursuant to the applicable double-taxation treaties between the United States and Country X or Y depending on the applicable example above.

#### (iii) Scenario: Dual-Resident Corporation and Stateless Income

Consider the following scenario:

1. U.S. Company A owns CFC X1, which is a manufacturing corporation incorporated in Country X, a high-tax jurisdiction.
2. The U.S. Company forms a sister corporation, CFC X2 in Country X.
3. CFC X2 is effectively managed and controlled in the United States and so it is a non-resident for the purposes of Country X's tax code.
4. CFC X2 enters into a contract manufacturing arrangement for CFC X1 to manufacture goods from

raw materials that CFC X2 will purchase from the U.S. company and provide to CFC X1, thus reducing CFC X1's profit.

5. CFC X2 will then sell through a branch established in the country of sale.
6. CFC X2 will not be taxed on its sales profits in Country X, because Country X treats it as a non-resident because its place of management is in the U.S.
7. The U.S. tax law treats CFC X2 as a Country X corporation because it was incorporated in Country X.
8. Because the income of CFC X2's sales is derived from the sale of products manufactured in Country X, this does not constitute Foreign Base Sales Company Income (FBCSI). In order for FBCSI to apply the sales income would have to be derived in connection with the sale of products both manufactured and sold for use outside CFC X2's country of incorporation (Country X).
9. Thus, CFC X1 will have reduced its tax payable to Country X without any subpart F income arising in CFC X2 because of CFC X2 is a foreign corporation to both Country X and the United States.<sup>96</sup>
10. CFC X2 is stateless.<sup>97</sup>

This is a key component of case studies to be examined subsequently in Article IV, Section E, where this article will be examining the tax structures of Apple, Inc. and Google, Inc.

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<sup>96</sup> *Id.*

<sup>97</sup> Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699 (2011), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1791769###](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1791769###) (last visited July 8, 2015).

### 3. *Transfer Pricing*

Tax strategies have two major overlapping goals: (a) deferral and (b) avoidance. In large part the tax strategies described above focus on the avoidance aspect, e.g. how applying disparate treatments of treaties escapes a high level of taxation in the source country by interposing a holding country with a favorable treaty network. Although avoidance is the goal, the practical result of most modern tax strategies is deferral. Sooner or later the reality is that shareholders will pressure companies to repatriate offshore profits to reinvest or distribute in the form of dividends.<sup>98</sup>

Each of the strategies described above involve the use of treaty provisions to legally reduce the amount of tax due and owing in one country versus another and shift the profits of a company from a high tax country to a low tax country. Contrarily, tax evasion would involve an illegal reduction in tax by relying on sovereign privacy laws to hide foreign profits and assets. Alternatively, some corporations use what is known as transfer pricing in order to further reduce tax. Depending on the methods used to establish the transfer pricing, some legal experts have argued that such techniques might also qualify as illegal tax evasion especially as the pricing applies to hard goods.<sup>99</sup>

Transfer pricing involves the application of prices to goods and services sold between related companies. The price of the goods sold should be the same as the prices that would be paid by unrelated parties, or a so-called “arms-length transaction.” “By lowering the price of goods and services sold by parents and affiliates in high-tax jurisdictions and raising the price of purchases, income can be shifted.”<sup>100</sup> The OECD Transfer Pricing Guidelines provide five

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<sup>98</sup> Jane G. Gravelle, *Tax Havens: International Tax Avoidance and Evasion*, CONGRESSIONAL RESEARCH SERVICE (Jan. 15, 2015), <http://fas.org/sgp/crs/misc/R40623.pdf> (last visited July 5, 2015); *Apple under pressure for new dividends, repatriation of cash*, MACNN (Mar. 11, 2013), <http://www.macnn.com/articles/13/03/11/wall.street.government.wants.more.of.companys.growing.cash.hoard/> (last visited July 5, 2015).

<sup>99</sup> *Id.*

<sup>100</sup> Gravelle. *supra* note 99 at 12.

methods to estimate an arm's length price of transactions and allocate profits between companies:

(i) **the comparable uncontrolled price method (hereinafter “CUP”)**, which involves observing comparable transactions between two independent companies and applying the same price for group companies;

(ii) **the cost plus method**, which involves approximating income from goods sold or services provided to the company within the group for a fair income level;

(iii) **the resale minus method**, which involves approximating the costs of goods bought from and services provided by a group company for a fair cost of goods;

(iv) **the transactional net margin method (hereinafter “TNMM”)**, which involves using a net profit indicator, referring in principle to the ratio of profit per item compared to the profit and loss account of the firm, a fair margin is applied to be considered “arm's length”

(v) **the transactional profit split method**, which involves considering each of the related parties relative value of their contributions to the profit or loss and splitting the profit appropriately.<sup>101</sup>

It is relatively simple to police a simple product that has a markup and other competitive goods offered for sale in the marketplace. Failure to sell those goods between related companies at fair market value, which is what parties negotiating at arms-length would pay, is a violation of the transfer-pricing rules. Intellectual property and intangible assets are the primary assets where transfer pricing remains relevant within international tax planning, largely for one reason: there is no competitive market to license these assets and there is only one customer and only one licensee – the company that

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<sup>101</sup> TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS, OECD (2010), <http://www.oecd.org/ctp/transfer-pricing/transfer-pricing-guidelines.htm> (last visited July 6, 2015).

exploits the intellectual property. New inventions, new pharmaceutical drugs, trademarks have nothing to be compared to that would effectively affix a value to the intellectual property.<sup>102</sup>

By transferring the intellectual property to a subsidiary in a low-tax jurisdiction and requiring every use of the intellectual property to pay high-royalties, the royalties are deductible in the high-tax jurisdictions and the income flows to the low-tax jurisdictions.

#### 4. *State Aid & Subsidies*

State Aid is a tool that is used by many jurisdictions to attract specific companies. It is “A grant of money made by government in aid of the promoters of any enterprise, work, or improvement in which the government desires to participate, or which is considered a proper subject for state aid, because [it’s] likely to be of benefit to the public.”<sup>103</sup>

As a domestic American example of State Aid consider Mercedes-Benz. In 2015, Mercedes-Benz USA (“MBUSA”) the United States subsidiary of Daimler, AG negotiated a subsidy with the Governor of Georgia, whereby MBUSA would relocate its headquarters from the high-tax state of New Jersey, which imposes its own corporate income tax of 9% in addition to the United States corporate income tax.<sup>104</sup> The State of Georgia imposes a corporate income tax of 6% in addition to the United States corporate income tax.<sup>105</sup> Although 300 basis points is a significant reduction, the State of Georgia also agreed to enact an “incentive package” valued at \$27,000 per job. MBUSA estimates that it will create 800 to 1,000

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<sup>102</sup> *Id.*

<sup>103</sup> *Supra* note 15.

<sup>104</sup> *Corporation Business Tax Overview*, STATE OF NEW JERSEY DEPARTMENT OF TREASURY [http://www.state.nj.usU.S/treasury/taxation/corp\\_over.shtml](http://www.state.nj.usU.S/treasury/taxation/corp_over.shtml) (last visited July 6, 2015).

<sup>105</sup> *Corporate Income and Net Worth Tax*, GEORGIA DEPT. OF REV., <http://dor.georgia.gov/corporate-income-and-net-worth-tax> (last visited July 6, 2015).

jobs in Georgia by moving its headquarters. This amounts to a subsidy of up to \$27 million USD.<sup>106</sup>

Article 107 of the Treaty for the Functioning of the European Union provides that “any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.”<sup>107</sup> In 2014, the European Commission opened an investigation into Amazon.com, Inc.’s arrangements with Luxembourg over favorable tax treatment of income from Amazon’s transfer pricing arrangements.<sup>108</sup> The decision involves Luxembourg’s validation of Amazon’s Advance Pricing Arrangement (“APA”). An APA is an agreement between various subsidiaries and branches of a multinational group to set prices based upon comparable prices, pricing methods and adjustments for various factors.<sup>109</sup>

Amazon’s structure is as follows:

1. Amazon Company 1 (AC1) and Amazon Company 2 (AC2) are based in the United States and own 100% of Amazon Europe Holding Technologies SCS (Lux SCS), a limited liability partnership.
2. For the purposes of Luxembourg law, Lux SCS is a transparent entity.

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<sup>106</sup> James Salzer, *Gov. Deal signs tax breaks for Mercedes-Benz staffers, private college*, THE ATLANTA JOURNAL CONSTITUTION (May 6, 2015), <http://www.ajc.com/news/news/state-regional-govt-politics/gov-deal-signs-tax-breaks-for-mercedes-benz-staff/nk9y6/> (last visited July 6, 2015).

<sup>107</sup> TFEU Treaty, art. 107 *opened for signature* March 25, 1957.

<sup>108</sup> David Meyer, *EU Publishes Details of Amazon Luxembourg “State Aid” Tax Probe*, GIGAOM (Jan. 16, 2015), <https://gigaom.com/2015/01/16/eu-publishes-details-of-amazon-luxembourg-state-aid-tax-probe/> (last visited July 6, 2015).

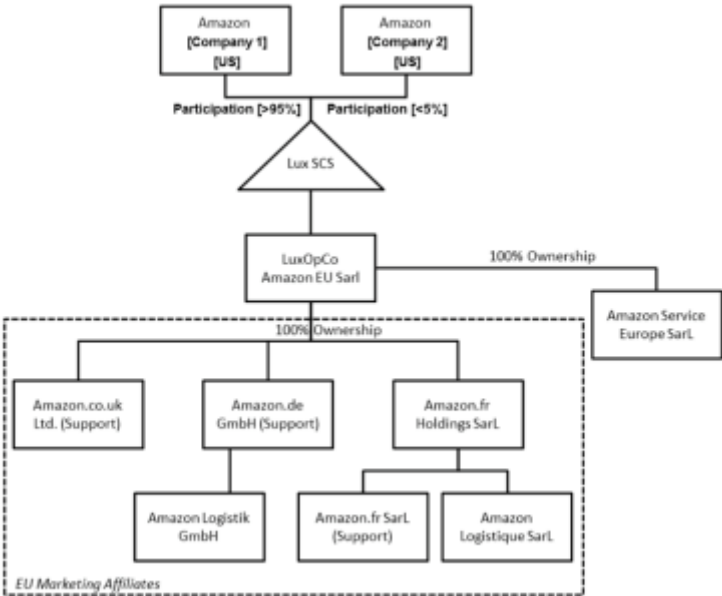
<sup>109</sup> STATE AID SA.38944 (2014/C) – *Luxembourg Alleged aid to Amazon by way of a tax ruling*, EUROPEAN COMMISSION, Brussels (Oct. 7, 2014).

3. For the purposes of U.S. law, Lux SCS is a corporation and tax is deferred on its profits until they are repatriated to the U.S. as a dividend.
4. Lux SCS owns all Amazon's intangibles and intellectual property, and licenses both of them to Amazon EU Sarl (LuxOpCo) for which Lux OpCo must pay a royalty to Lux SCS.
5. LuxOpCo operates all of Amazon's European Sites and owns all of the shares in Amazon's E.U. subsidiaries located outside of Luxembourg in the European Union.
6. Lux SCS also loans LuxOpCo and other related companies cash to provide operating capital to the group and the group pays Lux SCS deductible interest payments.<sup>110</sup>
7. As a result of this arrangement, Amazon shifts most of its profits from subsidiaries located in high tax European jurisdictions to Luxembourg, where they are not subject to tax and deferred under U.S. taxation until those profits are repatriated back to the U.S. in the form of a shareholder dividend or distribution.

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<sup>110</sup> *Id.*; *Proposed Treasury Regulations under Section 385 would have profound impact on related party financings*, PwC (Apr. 7, 2016), <https://www.pwc.com/U.S/en/tax-services/publications/insights/assets/pwc-proposed-section-385-regs-would-impact-related-party-financings.pdf> (last visited Mar. 15, 2017).





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Luxembourg applied the Transactional Profit Split Method to determine that Amazon’s transfer pricing arrangement, which favored placing profits in Luxembourg over other E.U. member states, was a fair practice and in compliance with Article 164 of the Luxembourgish tax code of 1967 (“LIR”) which gives no discretion to tax authorities.<sup>112</sup>

In comparing the U.S. example of Mercedes-Benz USA, whereby the State of Georgia enacted tax law solely for the purpose of attracting a single firm, and the E.U. example of Amazon obtaining a ruling that its APA was in compliance with Luxembourg law, it can be seen that a far greater latitude is given to United States taxpayers than to member states of the European Union, in this regard. However, in both cases, the governments will toe the line of legality in order to attract large businesses to their jurisdiction. The fact that Mercedes-Benz USA moved to Georgia, and that Amazon setup their European headquarters in Luxembourg, evidences that, at

<sup>111</sup> *Id.*

<sup>112</sup> Article 164 of the Luxembourg Income Tax Law of 1967; *supra* note 110.

the extremes, when governmental assurances are provided, tax can act as a major business driver.

#### E. The Present: Intellectual Property and Modern Tax Structures

In the context of intellectual property, the very nature of the property itself makes it a valuable tool for international tax planning. The features of intellectual property make it portable and relatively easy to relocate either by contractual terms or re-registering in foreign jurisdictions. When a product or good exploits a trademark or patent the company that manufactures that product or good must pay a royalty or licensing fee to the company that owns the intellectual property. In order for one company to control all rights to intellectual property that property must be sold and assigned to the other and those rights include the rights to receive royalties and licensing fees from that property. In other words, intellectual property could be compared to real estate in the sense that an assignment is a transfer of title to the property and the right to receive rental income for the property's use. Whereas a manufacturing company has to pay rent to use a warehouse, it would also have to pay a licensing fee to use the applicable trademark for a good, the patent in the way that the good operates or is constructed, and even a sum for confidential access to a trade secret in how the product is manufactured or what the recipe consists of.

By relocating intellectual property from a high tax jurisdiction to a low tax jurisdiction, as in the Amazon example above, the royalties and licensing fees relating to that intellectual property are booked in the low tax country, and thus, subject to taxation there.

Two major multinational companies, Google, Inc. and Apple, Inc., provide a good example of how these tax rules can be used to their benefit with *avant garde* tax strategies that take advantage of both intra-European and international tax rules.

1. *Back-to-Back License Structure with Double Irish Dutch Sandwich Case Study : Google, Inc.*

The first example, Google, utilizes many of the strategies described thus far. Google primarily derives its taxation benefits through use of the double Irish-Dutch sandwich strategy, U.S.

Check-the-Box Rules, the E.U. Interest & Royalties Directive, and general arbitrage between definitions of terms such as Tax Residence and Transfer Pricing Opportunities. To illustrate:

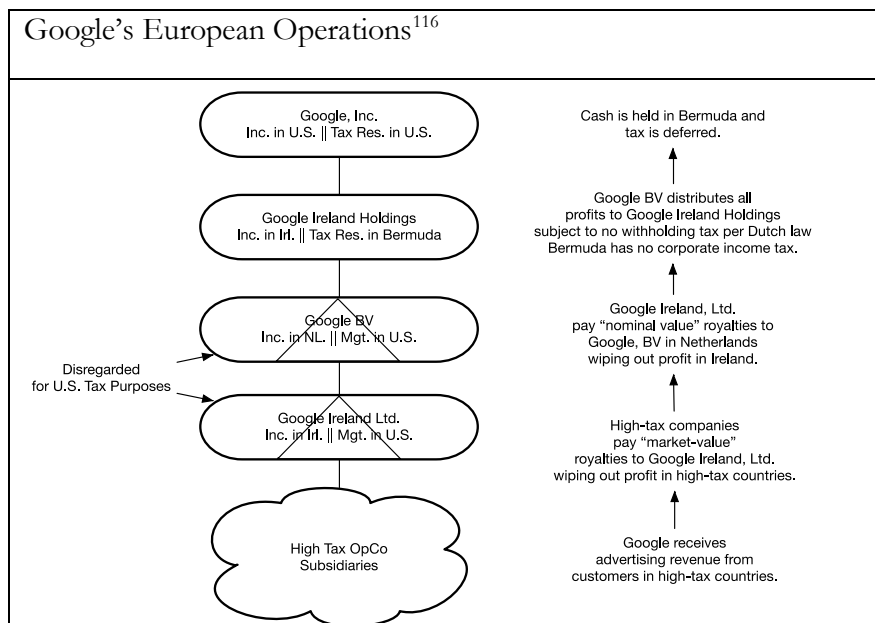
1. Google, Inc. transfers all of its intellectual property to an Irish holding company, Google Ireland Holdings, Inc., which has its company management and tax residency in Bermuda where the corporate income tax rate is 0%.
2. This company has subsidiary sales companies that sell advertising, Google's main source of revenue, to European markets ("High-tax OpCos").
3. However, sandwiched between the Irish holding company and the European subsidiaries is a Dutch subsidiary, Google, BV., and an Irish subsidiary, Google Ireland, Ltd.
4. Google Ireland, Ltd. collects royalties from the subsidiaries at market value and transfers them by paying nominal royalty fees to Google, BV. in the Netherlands. Google Ireland, Ltd. incurs these nominal royalty fees by licensing hard-to-price intangible assets from Google, BV., using one of the OECD transfer pricing methods, as explained by the Amazon example
5. Google BV. is incorporated in the Netherlands and the Company's management is located in the U.S.<sup>113</sup>
6. Google, BV. distributes its income to Google Ireland Holdings and is not subject to withholding tax on that distribution under Dutch law.
7. Google Ireland Holdings is a tax resident of Bermuda and subject to 0% corporate income tax.
8. This strategy allows the Irish operation to avoid "even the low Irish tax of 12.5% and, by using the Dutch sandwich, to avoid Irish withholding taxes -- which are

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<sup>113</sup> *Supra* note 98.

not due on payments to European Union companies -- per the E.U. Interest & Royalties Directive”.<sup>114</sup>

9. Because Google “Checks the Box” on Google Ireland Holdings and Google, BV. for U.S. taxation purposes, the royalty payments disappear when the entities disappear and all the U.S. sees are the fees from the operating company engaged in active business with Google Ireland Holdings, Inc., which has its tax residency in Bermuda.<sup>115</sup>



<sup>114</sup> Jane G. Gravelle, *Tax Havens: International Tax Avoidance and Evasion*, CONGRESSIONAL RESEARCH SERVICE, 12 (Jan. 15, 2015), <http://fas.org/sgp/crs/misc/R40623.pdf> (last visited July 5, 2015).

<sup>115</sup> Ruth Mason, *Tax Planning for U.S. Multinationals*, UNIVERSITY OF VIRGINIA SCHOOL OF LAW (2015).

<sup>116</sup> *Id.*; Jesse Drucker, *Google Joins Apple Avoiding Taxes with Stateless Income*, BLOOMBERG BUSINESS (May 22, 2013), <http://www.bloomberg.com/news/articles/2013-05-22/google-joins-apple-avoiding-taxes-with-stateless-income> (last visited July 8, 2015).

## 2. Case Study: *Apple, Inc.*

While Google takes advantage of intellectual property, transfer pricing, and royalty payments, Google also sells advertising, which is also intangible. Apple, Inc., America's largest company applies a tax that is quintessentially Apple as it is perhaps the most simple and innovative modern international tax planning technique in use. Here's how it works:

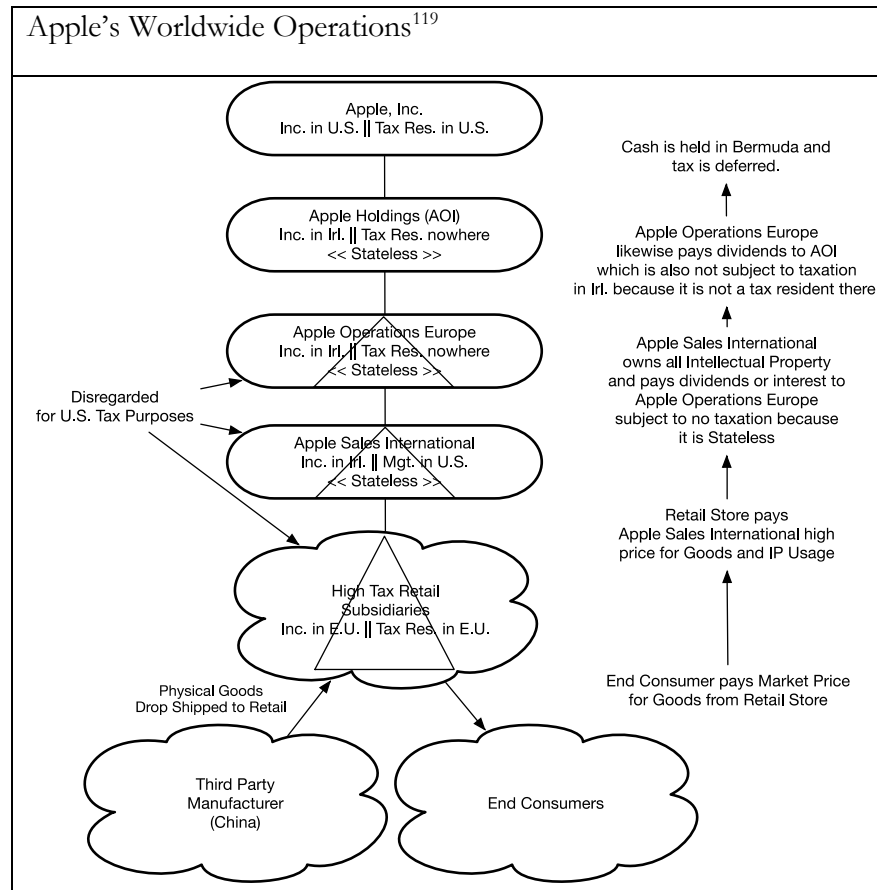
1. Apple, Inc. is a U.S. corporation and U.S. tax resident pursuant to U.S. law.
2. Apple sells goods to end consumers around the world through its retail stores in Europe, which are located in the various member states where they do business and are incorporated. The retail stores are tax residents in the relevant member states and are all disregarded entities for U.S. taxation purposes.
3. The retail stores are owned by Apple Sales International, incorporated in Ireland with Management and Control in the United States.
4. Apple Sales International is owned by Apple Operations Europe, incorporated in Ireland with Management and Control elsewhere.
5. Apple Operations Europe is owned by Apple Holdings, incorporated in Ireland with Management and Control in the United States.
6. Using arbitrage of the rules, Ireland considers Apple Sales International, Apple Operations Europe and Apple Holdings to be non-tax residents in Ireland because management and control lies outside of Ireland.
7. The United States considers these entities to be tax resident in Ireland because of their incorporation in Ireland but Apple anyway checks the box on the Retail Subsidiaries, Apple Sales International and Apple Operations Europe.

8. Apple transfers its Intellectual Property including the patents, trademarks and know-how that go into making its products into Apple Sales International.
9. Apple contracts with third party manufacturing companies in China at market price to manufacture its products for it.
10. Once each product is complete, the third party manufacturing companies transfer written title to the products to Apple Sales International, which also owns all of the Intellectual Property.
11. Apple then sells its products from Apple Sales International to its retail subsidiaries in Europe by transferring title and the items themselves are drop-shipped to the retail stores. The retail subsidiaries pay a high mark-up price for the hard goods, which include a component for the intellectual property licensing.
12. The retail subsidiaries re-sell the hard products to the end-consumers at a mark-up that is just sufficient to cover the cost of the retail subsidiary's operations leaving minimal profit in the high tax jurisdiction.
13. This leaves most of the income in Apple Sales International, which has a very large profit but is not taxable in Ireland because it is stateless.
14. As a result of this strategy, Apple has \$102 billion in offshore cash stored in Ireland, which cannot be repatriated because it would become subject to U.S. Taxation.<sup>117</sup>

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<sup>117</sup> Hearing Before the Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs United States Senate, One Hundred Thirteenth Congress, First Session, United States Senate (May 21, 2013), <http://www.gpo.gov/fdsys/pkg/CHRG-113shrg81657/pdf/CHRG-113shrg81657.pdf> (last visited July 10, 2015).

15. Like Google, Inc. the United States only sees the payments from the end consumers to Apple Holdings in Ireland. These streams through these stateless, check-the-box companies are disregarded so it is as if the customers are dealing directly with Apple Operations International.<sup>118</sup>



<sup>118</sup> *Supra* note 116.

<sup>119</sup> *Id.*; *supra* note 118.

V. FUTURE: PROACTIVE TAX PLANNING – CAN TAX DRIVE THE  
DECISION

Tax strategies such as those implemented by Apple, Inc. and Amazon.com have been subjected to public disclosure because governments and in particular the United States Senate and European Commission respectively have conducted inquiries into the practices of these multinationals and called upon representatives of these companies to testify publicly about their tax practices.<sup>120</sup> As a publicly traded company, exposure to publicity affects investor confidence and thus stock price in a more qualitative way.<sup>121</sup>

Perhaps one of the simplest resolutions would be for the United States to abolish the “check-the-box” rules. By doing so, the IRS Subpart F regulations would resume their intended meaning because companies would not be able to use payments of interest or royalties to a hybrid entity in order to eliminate taxable offshore Subpart F income. It is important to recognize that the IRS’ official justification for enacting the “check-the-box” provided in part:

Because the complexities and resources devoted to classification of domestic unincorporated business organizations are mirrored in the foreign context, the Service and Treasury are considering simplifying the classification rules for foreign organizations in a manner consistent with the approach . . . for domestic organizations.<sup>122</sup>

In other words, “check-the-box” was about providing simplicity in the tax code for multinationals. Although the IRS has implemented anti-abuse rules related to “check-the-box,” these rules

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<sup>120</sup> *Id.*; State aid SA.38944 (2014/C) – *Luxembourg Alleged aid to Amazon by way of a tax ruling*, EUROPEAN COMMISSION, Brussels, (Oct. 7, 2014).

<sup>121</sup> Ben Rooney, *Apple’s Tim Cook is Wall Street hero for a day*, CNN MONEY (May 21, 2013), <http://buzz.money.cnn.com/2013/05/21/apple-tim-cook-congress/> (last visited July 8, 2015).

<sup>122</sup> Internal Revenue Service, *Notice 95-14*, 1995-1 CB 297, 298 (Mar. 29, 1995).



do not apply for internal payments within a corporation.<sup>123</sup> According to the Office of Chief Counsel of the Internal Revenue Service, loans between a corporation and its disregarded branch in another country are disregarded for U.S. tax purposes.<sup>124</sup>

After the implementation of “check-the-box,” in countries like the United Kingdom and Germany where corporations are taxed at rates comparable to the United States, the tax bases dropped dramatically as profits were shifted offshore to low tax jurisdictions. In 1998, the IRS proposed new regulations to close the loophole and U.S. corporations began a massive lobbying effort to stop the implementation.

General Electric, PepsiCo, Morgan Stanley, Merrill Lynch, Monsanto and other major companies urged Congress to resist the change. The U.S., they said, was trying to be “the tax policeman for the world.” Allies in Congress dug in, and Treasury quickly rescinded the proposal.<sup>125</sup>

By 2000, over 8,000 disregarded entities were in existence with large concentrations in the Netherlands because of their specific treatment of royalties and interest discussed *supra*. By 2004, billions had built up in the Dutch bank accounts of major U.S. corporations and the United States Congress approved a tax holiday allowing these companies to repatriate the profits at a rate of 5.25 percent. Over \$90 billion USD was repatriated from the Netherlands alone.<sup>126</sup>

In 2009 when President Obama was elected, he included elimination of “check-the-box” loopholes as part of his agenda, however due to vehement opposition and threats that American companies would be bought by their foreign competitors, Obama

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<sup>123</sup> Jeff Gerth, *Corporations Couldn't Wait to 'Check the Box' on Huge Tax Break*, PROPUBLICA (Sept. 26, 2011), <http://www.propublica.org/article/corporations-couldnt-wait-to-check-the-box-on-huge-tax-break> (last visited July 8, 2015).

<sup>124</sup> *Memorandum 201420017*, OFFICE OF THE CHIEF COUNSEL INTERNAL REVENUE SERVICE (May 16, 2014), <http://www.irs.gov/pub/irs-wd/1420017.pdf> (last visited July 8, 2015).

<sup>125</sup> *Supra* note 124.

<sup>126</sup> *Id.*

retracted his position leaving “check-the-box” on the table as a valuable tool.<sup>127</sup>

A. The Value of Tax to Management Compared with Other Business Drivers: Case Study: Inversion

Although society has seen tax impact business in the context of structures and branch operations, perhaps the single biggest impact that tax can have on major corporations is the inversion, or the inversion merger. In the introduction, we examined how Boris Becker moved his residency for taxation purposes. We have also addressed how taxation based upon source and residence rules allows companies like Apple to take advantage of stateless income that is not subject to tax anywhere on the basis of residence. As discussed, the United States is unique in its approach to the taxation of worldwide income. Because the United States views the place of incorporation as the determining factor for tax residency, many U.S. corporations have moved their legal headquarters overseas by reincorporating. To do this, the U.S. company establishes or acquires another company in a country with a lower corporate tax rate and then calls the new country home.<sup>128</sup> As explained by The Economist:

When a company becomes foreign through a merger, or “inverts”, it no longer owes American tax on its foreign profit. It still owes American tax on its American profit. But that, too, can be minimised [sic]. Often, the group can shift debt to the American unit, or have it borrow from the foreign parent. It can then pay interest to the parent while deducting the sums involved from its American taxes. Several studies have found such “earnings stripping” common when companies invert. When Walgreens, an American chemist, announced plans to merge with Swiss-based

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<sup>127</sup> *Id.*

<sup>128</sup> John W. Schoen, *How Does a Corporate ‘Tax Inversion’ Work?*, NBC NEWS (Sept. 23, 2014), <http://www.nbcnews.com/business/taxes/how-does-corporate-tax-inversion-work-n209701> (last visited July 8, 2015).

Alliance Boots, Barclays, a bank, reckoned the move could save \$783m a year in taxes in this way.<sup>129</sup>

In practice, this is a relatively simple solution to a complex problem, however, the United States has changed the rules, so simply opening an office in London or Ireland, or even declaring a foreign country as the corporation's tax residence is insufficient to change the tax base of the corporation as further discussed below.<sup>130</sup>

The September 2014 regulatory change resulted in an increased fervor of actual substantive business acquisitions. In 2014, U.S. based medical device manufacturer Medtronic signed a deal for \$42.9 billion USD to buy Irish competitor Covidien. The new conglomerate's headquarters: Ireland; the effective reduction in corporate income tax: over 65% (from the U.S. rate of 40% down to the Irish rate of 12.5%). Shortly after announcing the merger, Medtronic announced a \$10 billion USD investment in new U.S.-based research and development commitments. We can surmise that the ability to make this investment may have been afforded as a result of the tax savings. With these figures, it is hard to imagine how tax could not drive these types of decisions in every major multinational corporation.<sup>131</sup>

According to Bloomberg News, as of April 2015, over 48 companies had reincorporated in low-tax countries since 1982, out of these 48, 17 have occurred since 2012. These include some of America's most cherished and valuable brands like Burger King, Mylan, and Aon.<sup>132</sup>

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<sup>129</sup> *Inverse logic*, THE ECONOMIST (Sept. 20, 2014), <http://www.economist.com/news/finance-and-economics/21618912-america-weighs-action-discourage-corporate-exodus-inverse-logic> (last visited July 9, 2015).

<sup>130</sup> Kevin Drawbaugh, *U.S. Treasury Moves Against Tax-Avoidance 'Inversion' deals*, REUTERS (Sept. 23, 2014), <http://www.reuters.com/article/2014/09/23/usU.S-tax-inversion-treasury-idUSKCN0HH2TM20140923> (last visited July 8, 2015).

<sup>131</sup> Charles Riley, *Medtronic buys Covidien for \$42.9 billion*, CNN MONEY (June 15, 2014), <http://money.cnn.com/2014/06/15/investing/medtronic-covidien/index.html> (last visited July 9, 2015).

<sup>132</sup> Zachary R. Mider, *Tax Inversion: How U.S. Companies Buy Tax Breaks*, BLOOMBERG NEWS (Apr. 21, 2015),

<b>Inversion Decade</b>			
<b>Year</b>	<b>U.S. company</b>	<b>Foreign acquisition target</b>	<b>New incorporation</b>
Pending	Cyberonics	Sorin	England
Pending	Wright Medical	Tornier	Netherlands
Pending	Steris	Synergy Health	England
Pending	Civeo	-	Canada
Pending	Applied Materials	Tokyo Electron	Netherlands
2015	Mylan	Abbott's generics unit	Netherlands
2015	Medtronic	Covidien	Ireland
2014	Burger King	Tim Hortons	Canada
2014	Horizon Pharma	Vidara Therapeutics	Ireland
2014	Theravance Biopharma	-	Cayman Islands
2014	Endo International	Paladin Labs	Ireland
2013	Perrigo	Elan	Ireland
2013	Actavis	Warner Chilcott	Ireland
2013	Liberty Global	Virgin Media	England
2013	Tower Group	Canopus Holdings Bermuda	Bermuda
2012	Stratasys	Objet Geometries	Israel
2012	Eaton	Cooper Industries	Ireland
2012	DE Master Blenders 1753	-	Netherlands
2012	Tronox	Exxaro Resources	Australia
2012	Rowan	-	England
2012	Aon	-	UK
2012	Jazz Pharmaceuticals	Azur Pharma	Ireland
2011	Alkermes	Elan Drug Technologies	Ireland
2010	Valeant	Biovail	Canada
2009	Altisource Port. Solut.	-	Luxembourg
2009	Hungarian Telephone	-	Denmark
2009	Ensco	-	England
2009	Tim Hortons	-	Canada
2007	Western Goldfields	-	Canada
2007	Argonaut Group	PXRe	Bermuda
2005	Lazard	-	Bermuda

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## B. Substance Requirements, Anti-Avoidance and Anti Treaty-Shopping

One area that has been subjected to significant scrutiny in many tax structures is overall substance. As discussed in the context of inversions, the U.S. Treasury used a form of Substance Requirements to curb U.S. corporations' ability to simply

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<http://www.bloombergtax.com/quicktake/tax-inversion> (last visited July 9, 2015).

<sup>133</sup> *Id.*

reincorporate elsewhere, or to use the acquisition of a much smaller foreign rival to change the company's overall tax residency.

Substance Requirements however, arise most prominently in the area of treaty shopping and the use of Special Purpose Vehicles ("SPVs"):

In order to qualify for tax treaty benefits, which is what SPV's are all about, the SPV will in most cases have to meet two criteria generally contained in tax treaties: (i) the SPV must be a tax resident of the State it is registered in; and (ii) the SPV must be the 'beneficial owner' of the income flow.<sup>134</sup>

The OECD model convention addresses substance in its "permanent establishment" and "beneficial ownership" rules. Revisiting the prior examples of *Prevost* and *Indofood*, we see two examples where courts treat similar situations differently. What occurred in *Prevost* could have been characterized as treaty-shopping. In 2011, the OECD introduced new language intended to address the ambiguities of the term "beneficial owner" contained in the model convention. In its summary, the OECD provided that in the case of the conduit company,

the recipient of the dividend is not the "beneficial owner" because that recipient does not have the full right to use and enjoy the dividend that it receives and this dividend is not its own; the powers of that recipient over that dividend are indeed constrained in that the recipient is obliged (because of a contractual, fiduciary or other duty) to pass the payment received to another person.<sup>135</sup>

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<sup>134</sup> Joseph Peters, *Netherlands: Worldwide Developments in the Tax Concept of Substance*, (Nov. 23, 2012), <http://www.mondaq.com/x/207914/tax+treaties/Worldwide+Developments+In+The+Tax+Concept+Of+Substance> (last visited July 8, 2015).

<sup>135</sup> *Clarification of the Meaning of "Beneficial Owner" in the Model Tax Convention*, OECD (Apr. 29 – July 15, 2011), <http://www.oecd.org/tax/treaties/47643872.pdf> (last visited July 8, 2015).

The European Commission has recently devoted a lot of attention to the Netherlands and whether by allowing the IP structures discussed herein they are creating harmful tax competition within the European Union. In response to European pressure, the Netherlands has also implemented its own national regime for holding companies and conduit companies that are established for the purpose of lessening the tax liability incurred from capital gains, dividends, and interest and royalty payments. These rules are as follows:

1. The entity should have sufficient equity (transfer pricing study required).
2. The equity should actually be at risk (no non-recourse situations).
3. The entity's gross profit margin should beat arm's length standards (transfer pricing study required).
4. At least 50% of the directors should be permanent Dutch residents (nationality irrelevant).
5. The directors should have proper professional qualifications in order to manage not only the entity but also its money flows; no 'dummies' allowed.
6. The books must be kept, and the annual accounts should be prepared, in the Netherlands.<sup>136</sup>

Additionally, in order to avail itself of treaty benefits, an entity must have a “permanent establishment” in the jurisdiction of one of the treaty parties. The OECD applies a “fixed place of business” test.<sup>137</sup> To wit: there must be a “fixed place of business through which the business of an enterprise is wholly or partly carried on.”<sup>138</sup>

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<sup>136</sup> *Id.*

<sup>137</sup> OECD: *Revised Proposals on Article 5 (Permanent Establishment) of the OECD Model Tax Convention*, PwC (Nov. 6, 2012), [http://www.pwc.com/en\\_GX/gx/tax/newsletters/tax-policy-](http://www.pwc.com/en_GX/gx/tax/newsletters/tax-policy-)

- **Fixed** means that there is a link between the place of business and the specific location, as well as a degree of permanence. An "office hotel" or "virtual office" may constitute a fixed place for a business for an enterprise that regularly uses different offices within the space. Contrarily, where there is no commercial coherence, the fact that activities may be conducted within a limited geographic area should not result in that area being considered a fixed place of business.
- A **place** of business. Means facilities used by an enterprise for carrying out its business. The premises must be at the disposal of the enterprise. The mere presence of the enterprise at that place does not necessarily mean that it is a place of business of the enterprise. The facilities need not be the exclusive location, and they need not be used exclusively by that enterprise or for that business. However, the facilities must be those of the taxpayer, not another unrelated person. Thus, regular use of a customer's premises does not generally constitute a place of business.

**Business** of the enterprise must be carried on wholly or partly at the fixed place.<sup>139</sup>

The European Union also has repeatedly upheld the "Freedom of Establishment" as one of the four fundamental freedoms available to E.U. citizens pursuant to the European Union treaty. According to the European Court of Justice's holding in *Cadbury Schweppes v. Commissioners of Inland Revenue*:

"[F]reedom of establishment is intended to allow the nationals of the EMBL States to participate, on a

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bulletin/assets/pwc-revised-proposals-article-5-oecd-model-tax-convention.pdf (last visited July 9, 2015).

<sup>138</sup> *Id.*

<sup>139</sup> *Model Tax Convention on Income and on Capital: Condensed Version, Commentary*, OECD (2014), [http://www.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2014\\_mtc\\_cond-2014-en](http://www.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2014_mtc_cond-2014-en) (last visited July 9, 2015).

stable and continuing basis, in the economic life of another State” meaning “the concept of establishment involves the actual pursuit of an economic activity through a fixed establishment for an indefinite period.”<sup>140</sup>

Only the establishment in the host State and the pursuit of genuine economic activity falls within the scope of the provisions on freedom of establishment. The Court in *Cadbury* found that concept of establishment has a specific meaning and must not be interpreted narrowly. Any person or entity that pursues economic activities that are real and genuine must be regarded as taking advantage of its right of establishment.<sup>141</sup>

In order to determine whether or not an entity pursues real and genuine business activity in the host country, the Court must look to:

“[T]he extent to which the CFC physically exists in terms of premises, staff and equipment . . . . If checking those factors leads to the finding that the CFC is a fictitious establishment not carrying out any genuine economic activity in the territory of the host Member State, the creation of that CFC must be regarded as having the characteristics of a wholly artificial arrangement.”<sup>142</sup>

As a final catchall measure, many jurisdictions have sought to combat the types of tax structures analyzed herein using what is known as a General Anti-Avoidance Rule (“GAAR”). Although there is no uniform or model GAAR, there are consistencies in their formulation.

1. Identification of a *scheme* (Australia) or *arrangement* as is seen in China, Ireland, South Africa and New Zealand.

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<sup>140</sup> *Cadbury Schweppes*, ECJ C-196/04, para. 53 and 54.

<sup>141</sup> *Id.* at para. 68.

<sup>142</sup> *Id.* at para. 67; Robert Agresta, *Written Observations by the Principality of Liechtenstein to the EMBL Moot Court in Cases E-28/13 and E-30/13 Sailorman a.o. v. Norway*, Sept. 22, 2014.



2. Quantification of a *tax benefit* (Australia, Canada, Hong Kong and South Africa) or *tax advantage* (for example in Ireland) associated with that arrangement.

3. A *purpose test*. Identification of a *sole purpose* (Brazil), *dominant purpose* (Australia) or *main purpose* (South Africa) of obtaining a tax benefit associated with the arrangement.<sup>143</sup>

The United Kingdom however, only applies targeted anti-avoidance rules and has not enacted a catchall measure. The United States does not have any form of GAAR and relies upon common-law doctrines of statutory interpretation to prevent certain types of arrangements. “In 2011, the judicially developed economic substance doctrine, under which certain types of tax benefits are disallowed if the impugned transaction lacks economic substance or lacks a business purpose, was codified in legislation”.<sup>144</sup>

## VI. SUMMARY, CONCLUSIONS AND PROPOSALS

In light of the forthcoming OECD BEPS proposals as well as the promulgation of GAARs and clarification of Model Treaty provisions, the core question becomes: will tax be a business driver in the future? In this Author’s opinion, tax will always be a business driver, however it will not drive business in the same way it does today. Sovereign nations want to attract major corporations to their tax base. Although their abilities to freely adapt laws to do so may be hamstrung by their existing obligations in treaties, or subjected to international pressures, countries will always want to compete in this regard.

The author cannot discount the success that the OECD has had in obtaining ratification of the Model Convention among major world powers. However, internal political pressures as described in

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<sup>143</sup> *General Anti-Avoidance Rules: What are key elements to a balanced approach?*, PWC TAX CONTROVERSY AND DISPUTE RESOLUTION ALERT (2012), [http://www.pwc.com/en\\_GX/gx/tax/newsletters/tax-controversy-dispute-resolution/assets/pwc-general-anti-avoidance-rules.pdf](http://www.pwc.com/en_GX/gx/tax/newsletters/tax-controversy-dispute-resolution/assets/pwc-general-anti-avoidance-rules.pdf) (last accessed July 8, 2015).

<sup>144</sup> *Id.*

the United States have successfully preserved seemingly absurd loopholes like “check-the-box.” These indicators seem to be contrary to the ideals presented by the OECD in the BEPS project. While diplomatic relations seem to drive international discussions for an equitable tax system in one direction, domestic pressures demand attention. Even the Netherlands’ revised substance rules take little effort for a large multi-national to fulfill. Moreover, the incentive has proven fruitful to low-tax countries. The prevalence of inversions and tax driven cross-border mergers are proof of this.

In introducing this topic, this Article broke tax into categories, e.g. taxes on consumption and taxes on income. However, what if both taxes could be replaced with another option. Felix Bolliger, lic.oec., HSG argues in his whitepaper “Micro Tax on All Monetary Transaction / Automatic Micro Tax on Debiting (AMTD)” that an automated tax could be implemented “free of any ideology and extremely abundant.” Bolliger argues that this type of tax “relieves stress and strain on producers and individual tax payers. Existing direct and indirect taxes become obsolete. The automatic micro tax on debiting helps to resolve the current international debt crisis.”<sup>145</sup> Moreover, the AMTD would force intra-European tax compliance with the E.U. principles against state aid and in favor of a free internal market.

Bolliger argues that the AMTD fulfills the goals of a tax system to be “fair, easy to understand and easy to apply,” and better than any other presently available tax methodology. Bolliger states:

In Switzerland, total fiscal income for year 2011 amounts to CHF 170 billion, which represent 30% of CHF 585 billion gross domestic product. *A micro tax of 0.2% on CHF 95'000 billion monetary transactions equally generates a national tax income of CHF 190 billion.*

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<sup>145</sup> Felix Bolliger, *Reinvent the System: Micro Tax on all Monetary Transactions / Automatic Micro Tax on Debiting (AMTD)* (working paper, Jan. 2013), <http://www.microtax.ch/wp-content/uploads/2016/12/AMTDC-Automatic-Micro-Tax-Concept-English-07.12.2016.pdf>.

Statistics issued by NYSE, Nasdaq, London Metal Exchange (LME) give a first idea about the size of international money flows. We are confronted with figures beyond common understanding. Foreign exchange transactions (Forex) alone amount to a daily volume of USD 4'000 billion, or roughly 7% of world GNP.<sup>146</sup>

While the proposal is radical, it addresses the fundamental paradigm laid out in the Introduction hereto. As long as there have been governments – there have been taxes. As long as there have been taxes – there have been strategies to avoid them. By eliminating pressures, automating the collection of taxes, and taking responsibility for their payment, the ability to avoid taxes is effectively eliminated. To the knowledge of this author, the AMTD has never been proposed to the OECD as an alternative solution. The tax is however, fair, equitable and international. If the OECD were braver and more innovative, it would take-on the AMTD or another similar automated means of taxation as a goal and abandon the BEPS project, which in the opinion of this Author, will ultimately be largely ignored at the last moment by the United States because of its own internal political pressures.

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<sup>146</sup> *Id. (emphasis added).*